ANALYSIS OF ANTITRUST ISSUES RAISED BY B2B EXCHANGES©

BY

ROBERT E. BLOCH
SCOTT P. PERLMAN
MAYER, BROWN & PLATT

FTC WORKSHOP ON BUSINESS-TO-BUSINESS EXCHANGES

JUNE 29-30, 2000

ANALYSIS OF ANTITRUST ISSUES RAISED BY B2B EXCHANGES©

BY

ROBERT E. BLOCH
SCOTT P. PERLMAN*

I. Introduction

A. In connection with its workshop on business-to-business ("B2B") exchanges on June 29-30, 2000, the Federal Trade Commission ("FTC") has posed a number of questions regarding the public policy implications of B2Bs, including:

1. What competition issues may be raised by B2B electronic marketplaces? What are likely procompetitive benefits, and what are possible anticompetitive concerns?

2. Under what circumstances are B2B electronic marketplaces likely to increase or diminish competition? What has been the experience so far?

3. How do B2B electronic marketplaces affect entry at the buyer or seller level? How does entry occur in the market for B2B electronic marketplaces?

4. What issues are relevant to structuring and implementing B2B electronic marketplaces in order to realize efficiencies and avoid competitive problems? For example, what mechanisms might be included to prevent inappropriate sharing of competitive, confidential information? Are any of these mechanisms likely to be impractical or undesirable from a business perspective?

5. Does the development of competition within and among B2B electronic marketplaces depend in part on any intellectual property rights relating to the design or operation of such marketplaces?

---

* **Mr. Bloch is a partner in the Washington, D.C. office of Mayer, Brown & Platt, where he practices in the area of antitrust counseling and litigation. Prior to joining Mayer, Brown & Platt, he was Chief, Professions and Intellectual Property Section, Antitrust Division, U.S. Department of Justice. Mr. Perlman is a partner in Mayer, Brown & Platt's Washington, D.C. office, where he practices in the areas of antitrust counseling and litigation, and Hart-Scott-Rodino compliance. Both Mr. Bloch and Mr. Perlman currently are counseling B2B exchanges.**

6. What implications, if any, do B2B electronic marketplaces have for market structure and market concentration? (See "Public Workshop: Competition Policy in the World of B2B Electronic Marketplaces," 65 Fed. Reg., 30120, 30122, (May 10, 2000)).

B. The following is a brief analysis of these issues as they arise in connection with the following hypothetical:

1. A, B, C and D are 4 major wholesalers of toys (the "Wholesalers"). Together they account for approximately 50 percent of all purchases from toy manufacturers.

2. The Wholesalers propose to form a business-to-business on-line exchange to facilitate transactions between themselves and both toy manufacturers and retailers (the "Exchange").

3. The primary purpose of the Exchange will be to eliminate costs from the toy manufacturer-to-retailer supply chain.

a. The Wholesalers believe that use of the Exchange for on-line purchasing will reduce transaction costs and facilitate "reverse auctions" -- in which sellers are required to bid against each other for a purchaser's business -- that will result in lower product costs.

b. The Exchange also will provide data on orders and inventory to all participants that they can use to manage production and inventory levels in a more cost efficient manner. While most of this data will be specific to the transactions being engaged in by the particular participant, aggregated data concerning other parties' purchases also will be provided. The data provided by the Exchange will include certain data on orders and inventory that had been provided to customers by the Wholesalers on an individual basis. The Exchange will provide this and other data for a fee set by the Exchange's board of directors.

c. In addition, the Wholesalers contemplate that the Exchange may engage in certain joint purchasing activities on their behalf, and may combine certain ordering and warehousing functions. For example, the Exchange may create a common ordering system that will be used by all of the Wholesalers, and may manage a process by which the Wholesalers' will lease space to each other in their respective warehouses in order to use available warehouse space in the most efficient manner possible.

4. The Exchange will be governed by a 5-member board composed of one representative of each Wholesaler as well as the CEO of the Exchange who will be hired independently.

   a. The Wholesalers will be prohibited from forming or taking an equity interest in any competing exchange for 5 years after formation of the Exchange, and will be prohibited from making purchases or sales through any other exchange for 3 years, after which each Wholesaler agrees to make 80 percent of both its purchases and sales through the Exchange.

   b. The Exchange Board may vote to admit other wholesalers as equity partners in the Exchange. Such members will be required to adhere to the same non-competition and purchase requirements as the Wholesalers.

   c. The Wholesalers also will encourage as many wholesalers, manufacturers and retailers as possible to conduct transactions through the Exchange. The Exchange Board will set criteria for participants, however, including standard technology that must be used by all participants and financial criteria.

II. Issues Raised by the Formation and Operation of the Exchange

A. The formation of a business-to-business marketplace like the Exchange by competitors is analyzed as a joint venture or competitor collaboration under the antitrust laws. See *Antitrust Guidelines for Collaborations Among Competitors*, issued by the FTC and the U.S. Department of Justice ("DOJ"), April 2000 ("Collaboration Guidelines"). See also "FTC enforcers believe B2B auctions are similar to JVs," *FTC Watch*, April 10, 2000, 6 (report of discussion by David Balto, Assistant Director, FTC Policy and Evaluation Office) ("Balto Article").

B. The formation of a joint venture by competitors can raise two general categories of issues under the antitrust laws:

   1. Structural issues under Section 7 of the Clayton Act, which prohibits mergers that are likely to substantially lessen competition or tend to create a monopoly; and

   2. Operational issues under Section 1 of the Sherman Act, which prohibits conspiracies that result in unreasonable restraints of trade.

C. The principal structural issues raised by the Exchange are:

1. Whether, by combining certain activities through the Exchange, such as providing data to customers on orders and inventory, the Wholesalers will be able to exercise market power, *i.e.*, the power to raise prices above competitive levels or to exclude competitors in any relevant market in which they provide products or services; and

2. Whether, by combining certain purchasing activities through the Exchange, the Wholesalers will be able to exercise monopsony power, *i.e.*, the power to drive prices for the purchased product(s) or service(s) below the prices that would prevail in a competitive buying market, thereby depressing output of the product(s) or service(s). See Collaboration Guidelines, Section 3.31(a)

D. The principal operational issues include:

1. Whether the Exchange is a legitimate joint venture that will produce new products or significant procompetitive efficiencies that the Wholesalers could not have achieved separately, or a cartel formed to enable the Wholesalers to fix prices, allocate markets or purchases, or commit other anticompetitive acts.

2. Whether the Exchange will facilitate collusion among toy wholesalers with respect to the prices of the products and services they sell to retailers, among toy manufacturers with respect to the prices of the products they sell to wholesalers, or among toy retailers with respect to the products they sell to consumers. Such collusion could result from the operations of the Exchange in a number of ways, including:

   a. Wholesalers will purchase such a high percentage of their supplies through the Exchange at the same prices that a large percentage of their costs will become standardized, which will make collusion on the prices of the goods and services they sell easier.

   b. Participation by the Wholesalers in the governance and operations of the Exchange, including meetings of the Board, will provide opportunities to discuss the costs of supplies and the prices of the products and services they sell.

   c. Wholesalers will obtain access to data provided to the Exchange concerning the prices at which competing wholesalers sell goods and services to retailers, which information could be used by competing wholesalers both to reach an agreement on prices and to monitor compliance with such an agreement.

d. Wholesalers will obtain access to data provided to the Exchange concerning the purchases of competing wholesalers, including information regarding the costs and quantities of such purchases, and other cost data (such as the internal cost of warehousing space) which information could be used by competing wholesalers both to reach an agreement on prices and/or to monitor compliance with such an agreement (*e.g.*, by monitoring costs and, indirectly, quantities sold to retailers).

e. Manufacturers will obtain access to data provided to the Exchange concerning the prices at which competing manufacturers sell goods to wholesalers, which information could be used by competing manufacturers both to reach an agreement on prices and to monitor compliance with such an agreement.

f. Retailers will obtain access to data provided to the Exchange concerning the prices at which competing retailers purchase goods and services from wholesalers, which information could be used by competing retailers both to reach an agreement on prices for the products they sell and to monitor compliance with such an agreement.

g. If one or more Exchange members at some point join a rival exchange, the participation of these members in multiple exchanges will result in collusion between the exchanges or members of the exchanges who compete.

h. The Exchange is over inclusive, *i.e.*, the number of wholesalers participating is in excess of the number needed to achieve any plausible efficiencies, and the large number participating makes the exercise of market and/or monopsony power more likely and makes collusion among the wholesalers easier to accomplish and more likely to be effective in increasing prices.

3. Whether the agreements by the Wholesalers and other equity investors in the Exchange not to form or become members of any competing exchanges are reasonably necessary to the procompetitive purposes of the Exchange, or are an unreasonable restraint on competition that will prevent the formation of competing exchanges.

4. Whether the commitment by the Wholesalers and other equity investors in the Exchange to make all or most of their purchases and sales through the Exchange will result in an anticompetitive degree of foreclosure to rival exchanges and to manufacturers and retailers not participating in the Exchange.

5. Whether criteria defined by the Exchange Board regarding which manufacturers, wholesalers and retailers are permitted to participate in the Exchange will result in excluded manufacturers, wholesalers and retailers being unreasonably foreclosed from access to Exchange participants that the excluded parties need to compete.

III. Impact of the Exchange on Competition, Entry and Market Structure

A. The threshold competition question regarding the Exchange is whether it is a legitimate joint venture or a cartel formed to raise prices or engage in other anticompetitive behavior.

1. A joint venture that constitutes an agreement by competitors to fix prices, or allocate markets, customers or suppliers is *per se* illegal under the antitrust laws; a legitimate joint venture is evaluated under the "rule of reason," under which the venture's actual or potential procompetitive benefits are weighed against it actual or potential anticompetitive effects. See Collaboration Guidelines, Section 1.2.

2. A venture will be viewed as legitimate if it provides a new product or service that the venture parties could not have provided acting separately, or if it involves substantial economic integration likely to result in significant efficiencies. See Collaboration Guidelines, Sections 1.2, 3.2.

B. Under these standards, it is clear that the Exchange should be considered a legitimate joint venture. The Exchange will provide a new type of product or service, an electronic marketplace available to all toy manufacturers, retailers and wholesalers, that the parties cannot provide on their own, and that should produce a number of significant efficiencies in terms of reduced transaction costs and more efficient management of inventory and production.

C. Further, a business-to-business electronic marketplace like the Exchange has the potential to increase competition among toy manufacturers, wholesalers and retailers, lower entry barriers and decrease market concentration at all three levels of competition.

D. Like the Exchange, most B2B exchanges with which we are familiar plan to create an "open platform" to which all buyers and sellers in their industry can gain access.

E. Such open access policies have the potential to make smaller buyers and sellers more competitive by putting them on the same platform, and making their products as easy to locate and evaluate, as those of better known rivals.

1. For example, a small toy manufacturer currently may not be able to compete effectively for many sales because it lacks the sales force and other resources to market its products effectively outside of its local area.

2. Access to the Exchange, on which its products can be offered to wholesalers and retailers throughout the U.S. and perhaps the world may enable such a manufacturer to compete for many sales currently beyond its reach.

F. Decreased transaction costs also may encourage increased entry and expansion on both the buyer and seller side in industries in which such costs are significant. In the previous example, for instance, a small toy manufacturer may find it is profitable to expand its plant or to open a new plant in a different part of the country because it now can access additional sales.

G. B2B exchanges that lower entry barriers and increase the competitiveness of smaller players also may result in decreased market share for established players. The result should be a more competitive market with lower prices and better quality products and services for consumers.

H. Of course, a B2B exchange only can produce these benefits if it is truly open. "Open" in this context should not mean that the Exchange Board is required to allow any party seeking access to have it, but rather, that the Exchange will employ reasonable, objective criteria in determining who may participate (*e.g.*, that participants be able to use the technology being employed by the Exchange for ordering and data collection, creditworthiness, etc.). See *Allied Tube & Conduit Corp. v. Indian Head, Inc.*, 486 U.S. 492, 501 (1988). On the other hand, if the Exchange Board uses arbitrary eligibility criteria to prevent smaller manufacturers, wholesalers or retailers from obtaining access to the Exchange, the Exchange could have anticompetitive effects. See *Allied Tube & Conduit Corp.*, 486 U.S. at 509-511 (affirming liability of fire safety association member for influencing association to adopt biased safety code that favored member's products).

1. As more and more transactions in the toy industry are conducted on the Exchange, these smaller players would be marginalized increasingly, and lack of access to the Exchange would become an ever greater barrier to entry. See *United States v. Terminal Railroad Association*, 224 U.S. 383

(1912) (railroad joint venture that owned and operated terminals violated Section 1 of the Sherman Act by excluding non-member railroads from using terminals where access to terminals was necessary for non-members to compete).

2. Open access therefore may be a critical factor in ensuring that an exchange plays a procompetitive rather than an anticompetitive role in the particular markets in which it operates.

I. The importance of open access is increased when entry by additional exchanges is difficult.

1. For a B2B exchange to form and operate effectively, it requires the participation of players of a sufficient number and size at each level of distribution involved, as well as access to the necessary software and technology for the exchange to operate.

2. Access to the necessary software does not appear to be a problem. As we understand the facts, several companies currently are offering or have announced relevant software packages, including Oracle, Ariba and CommerceOne, as well as a number of other companies.

3. Access to buyers and sellers of a sufficient size and number may present a more difficult problem, however.

   a. Thus far, it appears that exchanges in many industries are being formed by a small number of significant industry players (*e.g.*, auto manufacturers, major airlines, major pharmaceutical manufacturers, major retailers).

   b. This suggests that formation of an exchange may require a small number of large competitors to "anchor" the exchange and provide a sufficient initial volume of transactions to make the exchange's operations cost-efficient as well as to attract additional participants.

   c. In an industry in which all or many of such anchor participants already have joined a particular exchange, the formation of additional exchanges may be difficult.

4. In some industries, it may be the case that formation of a small number of exchanges, or even one exchange, is the most efficient outcome. In industries in which more than one exchange can function effectively, however, provisions that prevent exchange participants from participating

in rival exchanges or forming essential networks may raise entry barriers for additional exchanges significantly.

a. Non-competition provisions that prevent exchange members from forming or participating in rival exchanges can raise competitive issues under Section 1 of the Sherman Act. In general, agreements by actual or potential competitors not to compete are *per se* illegal violations of Section 1. Where such an agreement is ancillary to the procompetitive purposes of a joint venture, however, it is evaluated under the rule of reason.

    (1) The test is to show that the restraint is "reasonably related to, and reasonably necessary to achieve" the venture's procompetitive benefits.

    (2) To be "reasonably necessary," an agreement need not be essential; rather, it need only be the case that the parties could not achieve equivalent or comparable procompetitive efficiencies through "practical, significantly less restrictive means." Collaboration Guidelines, Sections 1.2, 3.2.

b. As described above, the Wholesalers forming the Exchange are prohibited from obtaining an equity interest in or forming a rival exchange for 5 years or conducting any transactions through a rival exchange for 3 years, and are required to make 80 percent of their purchases and sales through the Exchange thereafter.

c. To justify these restraints, the Exchange would need to be able to show, for instance, that they were reasonably necessary to attract investors who need some assurance that members will use the Exchange for a sufficient volume of their transactions to achieve contemplated efficiencies and make the Exchange profitable.

d. Even if the Exchange can make this showing, however, it still would have to demonstrate that the restrictions are valid under the rule of reason. Whether requirements such as those above covering these time periods and thresholds are on balance anticompetitive will depend on the facts of each particular industry.

e. If there are other significant wholesalers available to form rival exchanges, these provisions may have little effect.

f. If relatively few other significant wholesalers are available, however, (*e.g.*, if the Exchange is over inclusive in that it has more participants than are needed to achieve procompetitive efficiencies, and leaves too few wholesalers to form rival exchanges), these provisions, either separately or as combined, could increase the difficulty of new entry.

IV. Managing Information Sharing

A. An important aspect of many of the exchanges currently being formed are the types of information sharing described above in connection with the Exchange, which have the potential to increase the cost-efficiency of the supply chain significantly.

B. These information sharing activities also create a risk, however, that competitors participating in an exchange will be able to use that participation to obtain access to proprietary information regarding prices, costs and output of other competitors that can be used to facilitate collusion.

1. Our experiences with a number of exchanges suggest that these concerns can be managed through the appropriate use of devices such as pass codes and fire walls that ensure that each participant's access to non-aggregated information is restricted to data concerning that participant's own purchases and sales. Such safeguards should be sufficient to ensure, for instance, that one wholesaler can not access data indicating the prices charged by competing wholesalers, or the costs of purchases made by those wholesalers (other than when the wholesalers are engaging in legitimate joint purchasing activities).

2. The parties forming an exchange can further reduce the likelihood that improper information sharing will take place by promulgating strict antitrust and confidentiality guidelines that provide, among other things, that improper sharing of competitive information will result in severe penalties, including possibly requiring equity members to sell their interests in the exchange and/or prohibiting the offending party(ies) from being able to conduct business on the exchange.

3. With respect to aggregated data like the data the Wholesalers contemplate disseminating through the Exchange, the parties forming an exchange should act to ensure that such information cannot be used to facilitate collusion by adhering, where possible, to the safety zone for dissemination of fee-related data among competing health care providers contained in Statement No. 5 of the DOJ and FTC *Statements of Antitrust Enforcement Policy in Health Care* (August 1996), including:

a. The data should be collected by a third party (*e.g.*, an outside accounting firm or other consultant), or an employee of the exchange who is not a current or former employee of any competing member of the exchange;

b. The data should be more than three months old; and

c. There should be at least five parties providing data for each data point, no individual party's data should represent more than 25 percent on a weighted basis for any data point, and the data should be sufficiently aggregated so that they will not allow recipients to identify the prices charged or costs of goods for any individual competitor.

V. Monopoly and Monopsony

A. Formation of a business-to-business exchange can result in monopoly or market power in two different types of markets:

1. The market for exchanges in the industry being served by the exchange; and

2. The markets for products and services in which the exchange participants operate.

B. As noted above, in some instances, an exchange may be one of the few or even the only exchange in its industry.

1. This may be due to internal growth, restrictions on member participation in rival exchanges, mergers with other exchanges, or some combination of these factors.

2. Under these circumstances, it may be possible for an exchange to exercise market power by increasing the fees it charges participants for its services and/or by reducing the quality of those services.

C. Where competing members engage in joint production, research or marketing of products and services through an exchange, these activities can lead to the exercise of market power with respect to those products or services.

1. For example, the joint provision of data regarding ordering and inventory through the Exchange, some of which had been provided on an individual basis by the Wholesalers, could result in the exercise of market power with

respect to the fees for this data.

2. Such potential monopoly effects should be evaluated under the *Horizontal Merger Guidelines*. Under the Merger Guidelines, principal areas of inquiry would include whether (a) the venture will significantly increase market concentration in the relevant product and geographic market, and result in a concentrated market; (b) whether, in light of concentration and other factors, the venture is likely to have anticompetitive effects; (c) whether new entry or expansion by existing market participants will be timely, likely and sufficient in magnitude to deter any anticompetitive effects; and (d) whether the venture will produce efficiencies that cannot be achieved by the parties through other means. Merger Guidelines, § 0.2.

D. Where members of an exchange contemplate engaging in joint purchasing activities like those planned for the Exchange, they need to consider whether the exchange will be able to exercise monopsony power.

1. In general, under the Collaboration Guidelines, joint purchases accounting for 20 percent or less of the total purchases of any product or service in any relevant market are unlikely to raise monopsony concerns, while purchases exceeding this threshold need to be analyzed more closely. Collaboration Guidelines, Section 4.2.

2. To the extent that joint purchases through an exchange appear to be increasing to a level that could raise monopsony concerns with respect to any product or service, the parties may be able to address these concerns by:

a. Limiting the percentage of their purchases members are required to make through the exchange of the affected product or service; and/or

b. Limiting the number of exchange members who may participate in such purchases (*e.g.*, by not allowing additional members to participate in these joint purchases once purchases by existing members reach 30 percent of total purchases in the relevant market, or by rationing off slots to participants through an annual lottery).

VI. Conclusion

A. The FTC has raised a number of important questions regarding the potential competitive effects of B2B exchanges.

B. As the analysis above indicates, the creation and proliferation of B2B exchanges represents an important development that promises to bring increased competition and more and better products to consumers at lower prices in a broad variety of industries.

C. In order to ensure that the procompetitive potential of these exchanges is achieved, however, careful analysis of the antitrust risks posed by an exchange, as well as practical guidance regarding how to minimize or eliminate those risks will be essential.

D. We hope that this article is a useful starting point for discussion in what promises to be an ongoing dialog between practitioners and antitrust enforcement authorities, both of whom are in search of ways to ensure that B2B exchanges realize the significant efficiencies they promise.