Comments Regarding B2B Electronic Marketplaces

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Introduction

The New Economy has sparked a revolution in the way that businesses buy and sell products from each other as a result of the recent acceptance of the Internet by corporations. These “Business-to-Business” (or B2B) transactions are increasingly being done over Internet based net markets or what we called "B2B exchanges".

These B2B exchanges resemble stock exchanges in many ways, including the way they are set up and organized and the trading methods they employ – but they are trading physical commodities such as paper, car parts and shipping capacity or financial services like insurance and credit derivatives, rather that stocks and bonds.

Based on our combined experience of developing stock exchanges we have been studying these emerging B2B exchanges and realized that they all share the same fundamental design issues that stock exchanges have grappled with over the last 300 years!

In our book called “B2B Exchanges: The Killer Application in the Business-to-Business Internet Revolution” (ISI Publications), we analyzed the nature of this revolution in B2B transactions. We made the claim that “the Internet changes everything in B2B” and that most corporations will have to re-invent themselves over the next five years to remain competitive in the New Economy. Customers are becoming far more demanding as the Internet has created a once in a lifetime shift of power from the seller to the buyer. B2B exchanges, which are developing at Internet speed, are catalysts for this change.

The market for B2B e-commerce is already much larger than that for business-to-customer (B2C) transactions and it is predicted to grow much more rapidly. In our book we predicted that on-exchange transactions will exceed $600 billion in value (30% of the total) by 2004 in the U.S. alone: if B2B exchanges can capture revenues representing just 0.5% of this turnover, they will collectively generate $3 billion in revenue per annum by 2004 - and that excludes the rest of the world! Since we published the book, the Gartner Group has predicted that global B2B e-commerce will reach $7.29 trillion by 2004 and that 37% of this will be facilitated by B2B exchanges.

Potential Antitrust Issues Raised by B2B Exchanges

In our book we identified the potential for these many-to-many markets to bring together buyers and sellers from all around the world. The results can be a highly competitive virtual market with on-line auctions creating dynamic pricing, reducing manufacturers' costs of raw materials, parts and supplies. In addition, these net markets have the capability to tie together the manufacturer with its suppliers (Tier 1) and its suppliers' suppliers (Tiers 2 & 3). This can lead to greater efficiencies in the design of products and ultimately to a "build to order" business model that dramatically reduces manufacturing time, inventory levels and distribution costs.

On the other hand, we accept that virtual markets can still create the opportunity for collusion, unreasonable restraint of trade, abuse of market power and, in the case of buy side led exchanges, the power to drive purchase prices below free market prices (i.e. monopsony power).

However, we respectfully submit that there are a number of structural features that can help ensure that these dynamic new businesses are used to create the significant procompetitive efficiencies that they promise to deliver.

Trading System Design

The new feature of all these B2B exchanges is that they are using the ubiquitous connectivity standards of the Internet to enable companies to connect to each other, to connect to the exchange's central market and to power their electronic trading systems. By definition, no B2B exchange has a physical trading floor or relies on brokers communicating by telephone or fax to execute trades.

The direct result of this is that B2B exchanges have electronic pricing mechanisms which provide a full audit trial of all activity in the system and which can be "hard wired" to ensure that anti-competitive activities do not occur on the exchange. As we state in our book:

" The centralized pricing system is the most important function of an exchange and the exchange must seek to ensure the integrity of that pricing mechanism. The key elements of a fair system for qualified members are:

- *equal access;*
- *the order with best price has highest priority;*
- *first in, first out (FIFO);*
- *effective procedures to ensure that each seller's products are posted correctly and that buyer bids and orders are transmitted accurately;*
- *trades are consistently executed in accordance with the published rules of the exchange.*

Equal access means that every trading member has equal access to the exchange's trading system, irrespective of size or duration of membership. Price priority means that a new order which sets the best price (i.e. the lowest ask or the highest bid price must take priority over other orders with a less attractive price). FIFO means that at the same price the time of entry of an order sets the priority of that order, with the first order received by the exchange taking priority over subsequent orders received at that price. With a fully electronic, auto-matching system, these rules can be hard coded into the system software using sophisticated algorithms.

To the extent that the exchange's trading rules cannot be "hard-wired" into the trading system, the exchange must introduce and enforce the trading rules against the members.

The rules of a successful B2B Exchange will require members to honor the integrity of the exchange's pricing mechanism. This means that members must agree not to do anything that will hinder or disrupt the fair and orderly functioning of the market. This should include a requirement that traders will not seek to manipulate the market, either on their own or through collusion with other members (e.g. by spreading false information, misleading others about the true position of the market, or creating false trades to give the appearance of activity). All of these practices have a long and infamous history in the world of securities trading, and stock exchanges around the world have formed trade associations that issue standards of best practice and core principals for exchanges to implement in order to restrict them.

Finally, members should be under a general obligation not to mislead or deceive customers in advertising goods or services through the exchange or completing transactions through the exchange's systems."

Ownership Structures

Most traditional stock exchanges were set up by stockbrokers and are still exclusively owned by the brokers, e.g. NYSE and London Stock Exchange. This type of exchange operates rather like a "mutual society" or private club.

The NYSE is a perfect example of what happens when the broker members own an exchange. The original "Buttonwood Tree" Agreement that formally constituted the NYSE on 17 May 1792 (it was named after a Buttonwood tree at 68 Wall Street under which the brokers used to meet), states as follows:

"We the subscribers, brokers for the purchase and sale of public stock do solemnly promise and pledge ourselves to each other, that we will not buy and sell from this day on for any persons what-so-ever any kind of public stock at less than one-quarter percent commission on the special value of, and that we give preference to each other in our negotiations."

So the original purpose of forming the NYSE was anti-competitive - to enable the brokers to exclude other traders, to control access to the market and to control the prices at which stocks were bought and sold, and particularly, to control the level of the commissions charged by the brokers for trading on behalf of a client.

It was mainly due to the fact that the NYSE is, and has acted as a private club, that the US Government passed the Securities Exchange Act of 1934, which requires all National Securities Markets to be registered by the SEC. For example, in the 1920's the NYSE would protect members who were trading whilst insolvent, if they were long standing members, rather than kicking them out immediately.

By way of contrast, B2B exchanges are almost all being set up as "for profit", neutral market spaces. This follows from their objective of bringing as many buyers and sellers together as possible, in order to create dynamic pricing and to thus lower the cost of procuring supplies for buyers and expand the range of potential buyers for the suppliers. Some are being set up by independent entrepreneurs, like the Stojka brothers who founded PlasticsNet,. Some are being set up by a group of large players in that industry, like MetalSite that was set up by Weirton Steel, LTV Steel and Steel Dynamics. But in all cases they are seeking to be neutral and independent markets with open access to all players in that industry. **B2B exchanges that are truly open will have objective criteria to determine who may have access to the centralized, electronic marketplace and provide equal access. Equal access means that every trading member has equal access to the exchange's trading system, irrespective of size or duration of membership.**

Traditional stock exchanges like the NYSE are now all rushing to "demutualize" and become for profit companies with open access. The fixed commission structure adopted by the NYSE effectively prevented the brokers from competing on price and denied the investing public the economic benefits of competitive market forces. In the UK, the practice of imposing minimum fixed scale fees was cited as an anti-competitive restriction in an anti-trust case brought against the London Stock Exchange under the Restrictive Trade Practices Act of 1976. Despite SEC regulation from 1934, it was not until 1975 that the SEC made the NYSE give up its anti-competitive, fixed commission structure. Due to competitive forces the commission rates in the US for on-line trading are now below $10 a trade and even traditional brokers such as Merrill Lynch have been forced to significantly reduce their trading fees.

Now, just imagine that a modern B2B exchange - say PlasticsNet (www.plasticsnet.com) - tried to insist that suppliers could only access the market through a broker and that the broker could charge a commission which was fixed by the exchange! Due to the power of the Internet, the low barriers to entry and the low cost of establishing a competing exchange mean that such restrictions would not last long! All modern B2B exchanges should be for profit entities, which are subject to open market forces and should have a self-regulatory organization (SRO) structure in place.

The Advantages for Self Regulation

A B2B exchange can only ensure it is open and fair if it is prepared to regulate the users of the exchange's centralized market facility. The form of regulation most appropriate for an Internet-based exchange is "self regulation". An SRO imposes regulations on its own members and then enforces those regulations.

Self regulation is really enlightened self interest, since it is always in the best interests of the exchange to maintain an open and fair market place. Self regulation should be contrasted with the alternative forms of regulation, which include regulation by an industry-wide association or regulation by a governmental body. In our opinion, neither trade associations nor governmental bodies are sufficiently flexible to cope with the rapid development of the B2B market space.

Where a B2B exchange becomes dominant in a market place it may raise public pressure to regulate the operations of that market place. For example, if the PaperExchange.com becomes dominant as the price-setting mechanism for paper products world wide, then the prices determined on www.paperexchange.com will effect every business and every household product that uses paper (e.g. the daily newspaper). This could lead to the belief that such an important B2B Exchange should be required to operate for the public good, rather than purely as a private sector initiative.

This national interest ingredient may encourage the belief that some B2B Exchanges should operate as “quasi-public utilities” rather than purely as private sector, “for-profit” companies. This again would remove the powerful forces for good that a free and competitive market imposes on a B2B Exchange particularly as many of these exchanges are global.

B2B exchanges must adopt sound self-regulatory practices to avoid such misconceptions developing.

Monopsony Power

The main objective of B2B exchanges is to bring more buyers and sellers together, to create dynamic pricing and to thus lower the cost of procuring supplies. As such they empower the buyers by enabling them to contact more potential suppliers and by creating the potential for "reverse" auctions - where the buyer sets a price and the suppliers have to bid on it (with prices falling as the auction progresses). They also benefit suppliers because sellers from all over the world can access the whole range of potential buyers for their products. The use of traditional auctions allows the sellers to get buyers to bid competitively for their products.

What is fascinating about the Internet revolution in B2B e-commerce is that it has created a "once in a lifetime" shift in the balance of power from the supplier to the buyer. This is illustrated by the industry consortia which are being formed by the buy side. These buy side consortia are working together to combine their procurement operations to create one central, on-line market place. In each case you have a group of buyers realising that in the networked economy they can lower their procurement costs by creating a central exchange. In these B2B exchanges all the potentially suitable suppliers can link in to the exchange electronically over the Internet and the buyers can create dynamic pricing by getting those suppliers to bid in on-line auctions for some contracts (reverse auctions).

On the other hand, by combining their purchasing power through an exchange and restricting suppliers access to that exchange, the buyers may be able to exercise monopsony power and force the suppliers who are members to quote prices below those that would prevail in a freely competitive market. This danger is particularly prevalent in industries which are already dominated by a relatively small number of large purchasers rather than the large majority which are more fragmented.

However, providing these exchanges are set up as "for profit" commercial entities with open access, then these B2B exchanges would be in breach of their financial responsibility to maximize shareholder value if they were to subjectively restrict access to their markets. Imagine if the WorldWide Retail Exchange (the B2B retail store procurement exchange being set up by Target, Kmart, Safeway, Walgreen, DairyFarm and 13 others, www.worldwideretailexchange.org) decided to restrict access to a limited number of suitable suppliers/vendors. It would immediately be self-defeating. Initially, the retailers may be able to extract cost savings from those vendors which it admitted, but by limiting access to a small number of potentially suitable suppliers, the retailers would actually be reducing their chances of securing food, drugs, general merchandise and textiles of the right quality at a lower price and with the right after sales service etc.. In such a scenario, the retailers would risk driving their limited number of selected suppliers to depress output and ultimately to go out of business as they forced the prices down. Open market forces therefore dictate that this B2B retail store exchange will be open to the widest range of potential suppliers that prove that they can deliver goods of the quality and in the quantity and with the other service attributes that the retail stores require.

Conclusion

Calls for nascent B2B exchanges to be regulated are, in our humble opinion, premature. One of the reasons why the Internet has been such a driving force in the New Economy and has helped improve U.S. productivity is because to date the U.S. Government has taken a relatively “hands off” approach in both regulation and taxation. B2B exchanges are still at a very early stage of development and should not be burdened with over regulation. The key issue is that B2B exchanges can create more competition and promote efficiency and they should be given the opportunity to prove that. The Internet has created a "once in a lifetime" shift in the balance of power from the supplier to the buyer. In the face of such a dramatic reversal of the economic metrics it would be detrimental to rush in and apply Industrial Age regulatory structures to these emerging new B2B e-markets. It is free markets, low barriers to entry and easy access to start up capital, and not Governmental regulation, that will ensure that all B2B exchanges preserve open and equal access to their market spaces.

Most B2B exchanges are also global in scope so any regulation, which we do not recommend at this time, needs to be coordinated with other major governments in Brussels and Tokyo.

We therefore suggest that the FTC should refrain from premature regulation. However, we also suggest that the FTC should maintain a “watching brief” to ensure that B2B exchanges do not change their open structures in order to support anti-competitive features. At this stage, the FTC might focus its attention on those marketplaces where there is already a concentration of power in a small number of “bricks and mortar” buyers or sellers rather than the more fragmented markets.

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