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Antitrust & Competition
REVIEW

About Our Practice

Mayer Brown's Antitrust & Competition practice offers up-to-the-minute guidance concerning merger control, cartel investigations, distribution and licensing issues, alleged abusive conduct by dominant firms and state aid. Our group, which includes former US and European enforcement agency officials, has members located in our offices in the Americas, Asia and Europe as well as correspondent and other relationships with antitrust counsel throughout the world that enable us to provide truly global coverage. Our global resources and experience enable us to represent clients in high-stakes litigation, including litigation before the US Supreme Court and the European Courts of Justice; and represent clients in criminal and civil investigations. Further, our antitrust lawyers in Hong Kong and China are skilled at navigating the range of competition laws in the region, and offer clients the benefit of extensive China antitrust filing experience and strong relationships with key competition agencies. Our global capacity also allows us to manage multi-jurisdictional merger filings and advise on the applicability of national merger control regulations and to secure merger control clearances throughout the world.

Editors' Note

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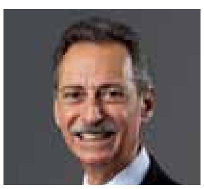

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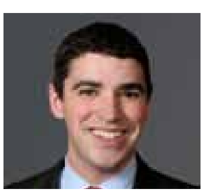

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Welcome to this issue of Mayer Brown's *Antitrust & Competition Review*. We are pleased to present articles from around the world on topics related to mergers and acquisitions, enforcement agency activity and developments concerning competitive practices.

Mergers & Acquisitions. The Hart-Scott-Rodino Act requires that large-scale mergers and acquisitions in the United States be reported in advance to the antitrust agencies. However, there are some special exemptions for energy companies, as well as exceptions to the exemptions. Scott Perlman helps unravel this tangled regulation.

Mergers between public hospitals have been on the rise in several parts of the world, with questions being raised as to whether competition law principles provide the most appropriate criteria for assessing such combinations. Kiran Desai examines the UK experience and its broader implications.

In China, the ministry responsible for merger review has been increasingly active and has attracted growing attention. Philip Monaghan looks at some recent merger cases and considers the implications for the agency's future practice. The same ministry also conducts national security reviews in China, which are related to, but not the same as, competition law reviews. Hanna Ha explains how this often misunderstood process functions.

Enforcement. In the United States, the Federal Trade Commission pursues investigations and challenges under a unique law that only it may enforce, but how the prohibitions of that law differ from what is prohibited under the other US antitrust laws has been a matter of controversy. Daniel Storino and Robert Entwisle describe the nature of the debate and what is at stake.

In Brazil, the council responsible for enforcement has been dramatically overhauled. Eduardo Molan Gaban reviews the council's achievements and examines its future.

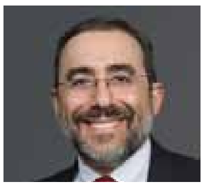
Practices. Mobile payment systems are becoming a hugely important driver of economic activity, but they also have attracted considerable attention under antitrust and competition law. Manu Mohan describes the European Commission's scrutiny of this phenomenon and provides some practical advice. In the United States, Richard Steuer reviews an important new decision scrutinizing loyalty discounts, which encourage customers to buy only one brand." He addresses what the decision could mean for sellers and buyers.

We hope you enjoy this issue of the *Review* and we welcome your questions and your comments. ◆

Energy M&A under the Hart-Scott-Rodino Act

Is there an exemption that applies to your deal?

Scott P. Perlman



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Introduction

At a time when there is significant M&A activity in the energy industry, it is critical for energy companies to understand how the premerger notification filing requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act" or "the Act"), and the regulations promulgated under the Act ("HSR Rules" or "Rule(s)"), may apply to their transactions. In fact, there are both energy-specific exemptions to the Act and other exemptions of more general application that can be used to exempt broad categories of energy mergers and acquisitions from HSR Act filing requirements. These exemptions are highly technical, however, and include a number of exceptions. As a result, transactions that exceed the Act's basic filing thresholds often must be reviewed carefully to determine whether any of these exemptions can be applied to the particular transaction at issue. Moreover, amendments to the HSR Rules and reporting form implemented in 2011 require parties to certain energy transactions, particularly those involving master limited partnerships ("MLPs"), to report additional information where the transaction does not qualify for an exemption. This article provides a brief overview of how these various provisions may apply to energy-related transactions, including the circumstances under which such transactions are and are not exempt.

HSR Act overview

Under the HSR Act and Rules, parties to acquisitions of assets, voting securities, and equity interests in non-corporate entities (e.g., limited liability companies, partnerships), that meet certain dollar thresholds, are required to file premerger notification forms with the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ"), and observe a waiting period — usually 30 days — before they are permitted to consummate the transaction. There are two basic filing thresholds. The Size-of-Persons threshold is satisfied where there is a person on one side of the transaction with $141.8 million or more in total assets or annual net sales, and a person on the other side with $14.2 million or more in total assets or annual net sales. The Size-of-Transaction threshold is met if the value of the transaction exceeds $70.9 million. Transactions valued in excess of $283.6 million meet the filing threshold regardless of the size of the persons. Transactions meeting these thresholds are reportable unless there is an applicable exemption.

Energy-specific Exemptions

Since 1996, the HSR Rules have included Rule 802.3, which provides specific exemptions for acquisitions of carbon-based mineral reserves. Under the Rule, an acquisition of reserves or rights in reserves of oil, natural gas, shale or tar sands together with associated exploration or production assets is exempt if the fair market value of such assets to be held as a result of the acquisition does not exceed $500 million. Similarly, an acquisition of reserves or rights in reserves of coal together with associated exploration or production assets is exempt if the fair market value of such assets does not exceed $200 million. "Associated exploration or production assets" means equipment, machinery, fixtures and other assets that are integral and exclusive to current or future exploration or production activities associated with the carbon-based mineral reserves that are being acquired, but does not include (1) any pipeline and pipeline system or processing facility which transports or processes oil and gas after it passes through the meters of a producing field located within reserves that are being acquired, or (2) any pipeline or pipeline system that receives gas directly from gas wells for transportation to a natural gas processing facility or other destination.

Significantly, in determining whether the $500 million or $200 million thresholds have been exceeded, the parties do not need to count the value of any non-producing reserves. As a result of this provision, acquisitions of oil and gas reserves with a total value substantially in excess of $500 million may be exempt (e.g., an $800 million acquisition consisting of $400 million in producing oil and gas reserves and $400 million in non-producing reserves). As noted above, however, the exemption does not apply to transportation or processing assets outside of the production field. In particular, such assets may include natural gas gathering systems, processing and treatment plants, transportation pipelines, storage facilities and terminals. In a transaction in which both exempt assets valued below the Rule 802.3 thresholds and non-exempt assets are being acquired, the parties must determine whether, viewed separately, the aggregate value of the non-exempt assets exceeds the $70.9 million size threshold, in which case a filing will be required for the acquisition of those assets.

Note that parties can take advantage of these exemptions regardless of whether the transaction is structured as an acquisition of assets or an acquisition of voting securities or non-corporate interests. Under Rule 802.4, where a direct acquisition of assets is exempt under Rule 802.3, the acquisition of an equity interest in an entity holding such assets also will be exempt provided that the entity also does not hold non-exempt assets valued in excess of $70.9 million.

Other Exemptions Applicable to Energy Transactions

In addition to the Rule 802.3 exemptions, there are a number of exemptions of more general application that can be applied to exempt transactions involving energy-related assets. A few of the most relevant exemptions are described below.

ACQUISITIONS OF NON-CONTROLLING INTERESTS IN NON-CORPORATE ENTITIES

There are many cases in which energy-related assets such as gathering systems and transportation pipelines are held in non-corporate entities, including limited liability companies (LLCs) and limited partnerships. Under the HSR Rules, acquisition of an equity interest in a non-corporate entity is not reportable unless, as a result of the acquisition, the acquiring person will hold a controlling interest in the entity. Thus, an acquisition that will result in the acquiring person holding only a minority interest in a non-corporate entity that holds energy-related assets is exempt regardless of the dollar value of the interest acquired. Further, this exemption applies even where the minority interest being acquired is a general partner or managing member interest that will give the acquiring person management control of the entity and its underlying assets.

ACQUISITIONS OF NON-CORPORATE INTERESTS IN FINANCING TRANSACTIONS

Under Rule 802.65, an acquisition of a controlling interest in a non-corporate entity is exempt from HSR Act filing requirements if (a) the acquiring person is contributing only cash to the non-corporate entity, (b) for the purpose of providing financing, and (c) the terms of the financing are such that the acquiring person no longer will control the entity after it realizes a preferred return. In recent years, it has become increasingly common for financial investors to contribute funds to entities that hold renewable energy projects, including solar power and wind projects, under terms that meet the requirements of this rule. Thus parties to such investments should consider whether their transaction qualifies for the Rule 802.65 exemption.

ACQUISITIONS OF ASSETS AND ENTITIES LOCATED OUTSIDE THE US

In an increasingly global energy industry, it is more likely that both US and non-US companies will be acquiring energy-related assets and entities located outside the US Even if the parties to such transactions that meet the Act's jurisdictional thresholds cannot take advantage of the exemptions discussed above, such acquisitions may qualify for one or more HSR exemptions relating to foreign commerce. In general, the acquisition of assets located outside the US is exempt so long as the non-US assets being acquired from the same acquired person did not account for aggregate sales in or into the US of more than $70.9 million in the acquired person's most recent fiscal year. A similar rule applies to acquisitions of voting securities in non-US corporations and controlling equity interests in non-US non-corporate entities. Where a non-US person acquires a non-controlling (less than 50%) voting securities interest in a non-US corporate issuer, the transaction is exempt. Where a non-US person acquires a controlling interest in a non-US corporate or non-corporate entity, or a US person acquires any voting securities interest in a non-US corporation or a controlling interest in a non-US non-corporate entity, the acquisition is exempt unless the target entity, including any of its controlled subsidiaries, holds assets located in the US with a current fair market value of more than $70.9 million, or had sales in or into the US of more than $70.9 million in its most recent fiscal year.

In transactions involving the acquisition of both US and non-US assets or entities, it may be helpful for the parties first to assess whether the US part of the transaction alone is valued in excess of $70.9 million, and if not, then determine whether the non-US part is exempt; if it is, the transaction is not reportable; if the non-US part is not exempt, the parties then should determine whether the value of the US and non-US parts together exceed the $70.9 million threshold.

ADDITIONAL REPORTING OBLIGATIONS RELATING TO MASTER LIMITED PARTNERSHIPS

In 2011, the FTC implemented changes to the HSR Act reporting form and regulations that were designed to obtain additional information in filings made by both private equity funds and MLPs, which frequently are used to hold assets in the oil and gas sector. The effect of these new rules can be illustrated with the following, simplified example. Assume GP is the general partner and holds a 5% interest in both MLP1 and MLP2, each of which owns natural gas pipelines. MLP1 now plans to acquire another natural gas pipeline in a transaction reportable under the HSR Act. Under the old rules, MLP1 was not required to report anything about MLP2's pipeline holdings, even if they competed directly with the pipeline MLP1 now is planning to acquire. Under the new rules, GP and MLP2 are considered "associates" of MLP1, and MLP1 must include information in its HSR Act filing regarding any entity in which GP or MLP2 holds a 5% or greater equity interest that operates in the same industry as the assets or company being acquired by MLP1. In this example, that would include information regarding MLP2's pipelines, including the geographic areas in which they operate. As this example shows, an MLP that is managed by a general partner that also manages one or more other MLPs, and is engaged in a transaction reportable under the HSR Act, needs to identify both relevant associate relationships and the resulting information it may need to report regarding those relationships.

Conclusion

As this discussion shows, there are many energy-related transactions that, while potentially reportable under the HSR Act, may qualify for one or more energy-related or more general exemptions from the Act's reporting requirements. Parties to transactions of the types discussed above should confer with counsel to determine whether their transaction is exempt, ensure that the transaction does not fall within an exception to the relevant exemption, and particularly if an MLP is involved, for guidance in identifying any associate relationships. ◆

Public Hospital Mergers: A Case for Broader Considerations than Competition Law?[1]

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In the European Union, concerns about increasing healthcare expenditures are a major motivating factor for introducing competition in hospital services. The EU healthcare landscape is dominated by public hospitals (that is, hospitals owned and funded by the State). This article addresses the question of whether mergers between public hospitals should only be decided upon by a competition authority on competition principles, or whether it would be better that the ultimate decision is taken by the government on the basis of broader considerations. In addressing this question, the focus, by way of example, is the situation in the United Kingdom.

This article is prompted by the change that occurred from April 2013 in UK law as it applies to public hospital mergers, that the second merger to be investigated under the new regime was subjected to a second phase investigation and ultimately blocked by the UK's Competition Commission (CC),[2] and there has been much criticism stemming from the matter. An indication of this criticism is that at the July 2, 2013 meeting of the UK Parliament's Health Committee, in response to a question the Secretary of State for Health stated that "It is a concern to me…I want to make sure that they [the Office of Fair Trading] properly consider the benefits and also that it doesn't take too long". In responding to a question about consideration of amended legislation, he said "If we thought there was a serious problem in terms of the structures…then we would consider it, yes."

Unique Aspects of Public Hospital Mergers

Hospital mergers have particularities that make analysis complex. First, there tend to be few market players and, typically, the market(s) of relevance are oligopolistic or even monopolistic for certain services and in certain areas. Further, entry and exit are costly and, as a highly regulated market, it may in particular areas be impracticable or simply not allowed by the regulator/government.

Most problematically, hospital services are credence goods—i.e., a good whose utility impact is difficult or impossible for the consumer to ascertain. In contrast to experience goods, the utility gain or loss of credence goods is difficult to measure both before and after consumption. However, the seller of the good knows the utility impact of the good, creating a situation of asymmetric information. Examples of credence goods include vitamin supplements, education and car repairs.

One example of how this may create market effects is that the least expensive products might be avoided in order to avoid suspected fraud and poor quality. So a restaurant customer may avoid the cheapest wine on the menu, but instead purchase something slightly more expensive. However, even after drinking it, the buyer is unable to evaluate its relative value compared to all the wines they have not tried (unless they are a wine expert). This course of action—buying the second cheapest option—is observable by the restaurateur, who can manipulate the pricing on the menu to maximise their margin, that is, ensuring that the second cheapest wine is actually the least good value.

Dealing with this information asymmetry has led some, and this is the case in the United Kingdom, to focus on customer choice. This means ensuring there are choices and improving the information and information delivery mechanisms to enable customers to make informed choices. Such choices tend only to be relevant for elective care (that is, a health service that is chosen by the patient or doctor, in contrast to accident and emergency services).

Another important distinction of hospital services is integrated care, namely, the need for multi-disciplinary teams both across specific health services and between health and social care. Integrated care is a requirement of patients and, therefore, a concern of the regulator/government.

Integrated care needs to be a part of the market offering and may require hospitals to co-operate in the provision of patient care. For example, in England, many hospitals have formed networks for the treatment of cancer. This allows them to share best practice, to transfer patient records effectively between organisations and to ensure that patients requiring specialist treatment receive care in the specialist hospitals best placed to provide that care. A hospital merger would need to be considered in this context so that cooperation is not adversely affected and that such networks do not become anticompetitive structures.

Finally, the sector is both economically and emotionally significant, and is therefore politically significant. It is estimated that expenditure in England on publicly provided elective hospital services was around £12 billion in 2012. The sector also raises emotions in the customer (patient and their relatives) and stakeholders (e.g., doctors). Consequently careful consideration of the outcomes of applying competition law to this sector is required.

Market Definition

PRODUCT MARKET

The definition of "product market" has two main complexities for public hospital mergers. First, there is a multitude of different hospital services. The International Statistical Classification of Diseases and Related Health Problems (ICD), is the United Nations-sponsored World Health Organization's standard diagnostic tool for epidemiology, health management and clinical purposes. There are currently 14,400 different ICD codes, and some countries have felt the need to supplement the ICD through introducing codes dealing with medical procedures, and/or use their own codes. In the United Kingdom, there is a tendency to use the Office of Population Censuses and Surveys Classification of Interventions and Procedures (OPCS-4), which is a procedural classification for the coding of operations, procedures and interventions performed during in-patient stays, day case surgery and some out-patient attendances in the NHS.

Second, there are different participants in the market, with different demand and supply factors, leading to blurring of the market definition. For example, the patient has an illness. The doctor works in a particular hospital and, thus, that hospital will have a specialty. The hospital will typically offer a multitude of different yet interrelated services. The payer (the government or, in the case of the UK, increasingly in the first instance a set of purchasers that are autonomous from the government) faces a multiplicity of different costs: diagnostic tests, drugs, medical devices, ancillaries, room and board, etc., none of which are of concern to the patient. However, the patient may need different services and, given the issue of integrated care identified above, these component services may be offered by different (competing) hospitals.

Seeking to facilitate analysis, hospital services can be clustered based on similar medical resource requirements (primary, secondary and tertiary care services), similar duration (inpatient and outpatient services), or on similar complexity and volume. In relation to the latter, market commentators have offered different suggestions. For example, Zwanziger Service Categories, based on a paper by Zwanziger, Melnick and Eyre (1994), creates "diagnostic related groups" (DRGs) and identifies 48 service categories, where the emphasis of the definition is on the doctor as the key input into hospital treatments. Such analysis can lead to opposite problems. Thus, statistics at the cluster level that do not appear problematic may mask issues in underlying categories, while issues in underlying categories can complicate a case that looks nonproblematic at the cluster level.

As was noted previously, the UK's competition authority has blocked the first public hospital merger that was subject to a full investigation, following the regime change in April 2013. The summary of its conclusion on product market definition in its decision indicate the complexities involved:

> (a) Each specialty constitutes a separate market. There may be a degree of differentiation within specialties and any constraint at sub-specialty level will be taken into account, when relevant, in our competitive effects assessment.
>
> (b) Within each specialty: (i) We treat outpatient and inpatient as separate markets and we note that there is an asymmetric constraint between inpatient and outpatient, with inpatient providers capable of readily supply-side substituting into outpatient services but not vice versa. We considered day-cases as part of the relevant inpatient market. (ii) Outpatient services should not be further separated according to whether or not the services can be provided in community settings, but certain services are provided only in the community and should be viewed as separate markets. (iii) Non-elective and elective activities are separate markets, although the provision of elective activities may be constrained to some extent by non-elective providers.[3]

GEOGRAPHIC MARKET

Geographic market is an even more complex subject than product market definition. Local market analysis techniques are critical and the case experience of local market mergers in other markets offers some insight. Thus, isochrones analysis (determining the geographic market by reference to the locality bounded by a travel time, for example, 20 minutes journey time by car) is a technique that can be relevant.[4] Diversion ratio analysis (surveying where customers would go if a particular site was temporarily closed), may also provide insight, as could the more complicated related technique of critical loss analysis (measuring when the lost "business" reaches a level such that it does not make sense for the hypothetical monopolist to raise prices).

Overlaying these techniques, it is necessary to consider the particularities of hospital services. For example, in many countries in Europe, emergency services are obliged to take accident and emergency patients to the hospital nearest to the where the patient has been found. For elective care, the degree of choice and information asymmetry is important. Many patients will be directed to a hospital by their general practitioner, or will naturally go to the hospital of choice of the specialist doctor they are seeing (who may have to choose that hospital because the specialist doctor has a working relationship with it).

Analysis of geographic market definition is particularly important given the experience of hospital mergers in the United States. Between 1993 and 2000 there were more than 1000 hospital mergers. The antitrust agencies (the Department of Justice and the Federal Trade Commission) challenged only seven of these mergers, yet lost in each case. As a result of that set-back, the two agencies did not challenge a hospital merger for several years. A full review by the agencies as to the actual effect on the market of past mergers led the agencies to conclude, in relation to geographic market analysis, that the methods used by the courts to define geographic markets in past hospital merger challenges lead to markets that are overly broad, mistakenly implying that some anticompetitive hospital mergers are innocuous.

In the hospital merger challenges of the 1980s and 1990s, courts relied on the Elzinga-Hogarty (EH) test to establish the boundaries of hospital geographic markets. The EH test posits that a relevant antitrust geographic market can be defined as an area for which the product flows into and out of the area are sufficiently small. In the context of hospital mergers, the first step of implementing the EH test is to designate a circle or group of zip codes that contain both of the merging hospitals. If most of the patients treated at the hospitals in this area also reside in this area (i.e., the inflows are small) and most of the patients residing in this area seek treatment at hospitals in the area (i.e., the outflows are low), then the area is an EH market.

The thresholds used by the courts to define flows that are sufficiently small range from 10 to 25 percent. If either the inflows or outflows exceed the threshold, the market is expanded (usually by adding adjacent zip codes) and the inflows and outflows are recalculated until an area is obtained with inflows and outflows both below the threshold. Some economists have long argued that the use of the EH test in hospital merger cases is inappropriate and leads to geographic markets that are too broad, especially in and around urban areas where the inflows are typically large, as rural and suburban patients seek care at the larger hospitals in the city. Courts using the EH test in hospital merger cases have, in some cases, defined geographic markets that are over 100 miles in diameter.[5]

It is perhaps not surprising that the Office of Fair Trading (OFT) commissioned a report into market definition.[6] While the report addresses private healthcare services (PH), its consideration is also relevant to geographic market definition in relation to public hospital mergers. As the reviewers noted:

> Techniques for geographic market definition in PH have been examined in great detail in the academic literature, as well as in government reports, competition investigations and court cases. The majority of the literature differentiates between the traditional, simpler techniques developed in the 1980s and 1990s, and the more complex and recent approaches. Overall, these techniques represent a broad spectrum of approaches that are characterised by different degrees of theoretical soundness, complexity, data requirements

and the extent to which they have been tested empirically or have established precedent.

For the UK, the reviewers' opinion was that the simpler techniques (isochrones or fixed-radii) were likely to be more relevant, principally because of the paucity of data available. However, a multi-layered approach to geographic market definition is suggested, depending upon the health services in consideration and the type of hospital. For example, A&E services are likely to have smaller catchment areas compared to elective cosmetic surgery, while a large teaching (or university) hospital is likely to have a larger catchment area than a limited service community hospital.

Reasons for Public Hospital Mergers

One of the UK government's policies is that it wants the NHS to become more efficient to free up funds for treating patients and keeping up with new treatments. On July 2, 2013, at the meeting of the UK Parliament's Health Committee, the Secretary of State for Health said that "mergers between NHS providers were important to improving efficiency…." This is consistent with and an expression of the UK government's emphasis on competition, which has been an important part of the UK government's NHS policy since 2000, and has antecedents in changes made since 1997.

Hospital mergers are intended to improve or sustain clinical quality, reduce operating expenses, increase revenue, reconfigure service delivery, rapidly acquire new skills or technologies, improve access to capital, and be able to afford to provide new services that were otherwise prohibitive for either hospital to acquire on its own.

Given the above, it is perhaps surprising that the view of the vast majority of commentators— generally, and not just in the UK—is that hospital mergers produce little benefit. A paper published in 2012[7] examined hospital mergers in the UK between 1997 and 2004. It focused on short term general (referred to as acute in the UK) hospitals. During the period studied, about half of the short term general hospitals in the UK merged. The study examined the impact of mergers on a large set of outcomes including financial performance, productivity, waiting times and clinical quality. The conclusion in the paper is that "such mergers often produce little benefit" and that "the findings suggest that further merger activity may not be the appropriate way of dealing with poorly performing hospitals."

A paper published by McKinsey & Company in 2012[8] states in its introduction, "Many hospital mergers fail. But when a merger is supported by both a compelling strategic rationale and strong pre-and post-deal management, the impact achieved is impressive." In a later article published in the UK's *Health Service Journal* the McKinsey authors confirm the general view when stating that "unfortunately, examination of the evidence from previous hospital mergers suggests very few have delivered significant improvements in clinical quality or financial performance." The authors add that "our research — an examination of more than 700 mergers around the world, combined with surveys, interviews and literature review — suggested the primary reason was the absence of substantial changes in service delivery."

In aggregate, studies consider a large set of metrics in considering hospital performance, for example, mortality rate, teaching status, staff per bed, complication rates, high-tech services, overall reputation, newspaper ranking, number of hospitals within X drive time, standard deviation of distance to nearest four hospitals, elective predictive patient flows, total admissions, length of stay, total income, income deprivation index for catchment population, prevalence of private hospitals, deaths after surgery, and hip-replacement readmissions. These metrics clearly make the potential for a complicated and difficult analysis. It is perhaps for this reason that despite the general view held by commentators that hospital mergers do not bring benefits, some commentators are more nuanced.

For example, in a paper published in November 2012 by the Centre for Health Economics at the University of York[9] the theoretical and empirical literature on competition and quality is reviewed. The authors' conclusion following a review of the theoretical literature is that there are gaps in the theory and further modelling work should be undertaken.

Perhaps a Broader Government View on Mergers Would Be Better?

Prior to April 1, 2013, the UK government, or an agency that was directly accountable to the Department of Health, made all decisions regarding public hospital mergers. Since that date, however, the UK has placed mergers of most public hospitals into the competition mainstream. This might result in competition law applying to activities that under EU law are able to be exempted from competition law oversight because the public hospitals, at least in part, are entrusted with the operation of services of general economic interest, per Article 106 of the Treaty on the Functioning of the European Union (TFEU).

In Part I, above, it is identified that the particular characteristics of public hospitals suggest that careful consideration should be given to the outcomes of applying only competition law to public hospital mergers. These characteristics include, most notably, that hospital services are credence goods, that they have significant political and economic weight, and that the different interests of the many participants may mean that competition laws, and the authorities that implement these laws, are not able to address all of the relevant public policy and societal goals.

In Part II, the difficulties of product market and geographic market definitions are identified. Generally, these difficulties are not a new challenge for competition authorities, nor are they ones that the authorities cannot meet. However, at least in the context of the United Kingdom, it might be unrealistic to consider that the OFT would have the time or resources to address the complexities, and this concern might even apply to the CC.[10] With experience, though, the analysis of hospital mergers by the OFT or CC should become more efficient. The test that the CC must consider—the SLC test[11]—and so whether or not there is an anticompetitive outcome, allows the CC to consider any actions it proposes to take on customer benefits – s.35(5) Enterprise Act 2002 (EA 2002). Despite this reference to customers (patients), it is unlikely that the CC could, through this provision alone, consider the broader societal effects of a merger.

In Part III, above, it is identified that public hospital mergers are being encouraged through public policy and the introduction of competition into the NHS. This is despite the general record indicating that mergers do not bring benefits. Moreover, there are a host of potential benefits that merging parties seek—although profit maximization is not typically one of them. These nonpecuniary benefits could still be assessed in terms of the economic unit of utility. However, such analysis may be outside the experience and perhaps capability of most competition authorities as the private utility benefits of the merging parties needs to be measured together with the effect on the utility of other stakeholders (for example, individual doctors or the government which is the ultimate funder in the UK).

The above raises the thought that perhaps a broader government view on public hospital mergers would be preferable to the current method where a competition authority makes the decision based strictly on competition law and principles.

In relation to the UK, one possibility of allowing government to take the ultimate decision on the basis of broader considerations, without having radically to alter the new regime, and maintain competition principles as a key pillar for assessment, is to allow the Secretary of State to issue a "public interest notice" under the EA 2002, effectively allowing the Secretary to be the ultimate decision maker.

The Secretary may, prior to the OFT deciding to whether to refer a merger to the CC, issue a public interest notice.[12] Such a notice is issued if the Secretary believes that a "public interest consideration" may be relevant to the merger.[13] A public interest consideration is a consideration listed in section 58 of the EA 2002. The list of public interest considerations may be amended, removed or extend by order of the Secretary of State.[14] While no health subjects are currently listed, they could be inserted by the Secretary through a relatively simple and fast procedure. Indeed, the Secretary can simultaneously issue a public interest notice and commence the procedure to have a new subject determined to be a public interest consideration. The Secretary has similarly intervened in relation to large bank mergers in the UK, allowing mergers to proceed even though the CC concluded that the SLC test was met.

There are various potential outcomes from the use of an intervention notice, but in short it allows the Secretary to block a public hospital merger that otherwise would have been permitted on competition grounds, or to allow a public hospital merger that otherwise would have been blocked on competition grounds.

Conclusion

When considering the merger of public hospitals, competition authorities arguably should address issues beyond those that are normally considered. Further, while competition law and principles should remain a key element in the analysis, there is justification for making the decision based on broader considerations than competition law. ◆

Endnotes

1 This is an abbreviated version of the article published in the December 2013 issue of *European Competition Law Review*.

2 The proposed merger between the Royal Bournemouth and Christchurch Hospitals NHS Foundation Trust and Poole Hospital NHS Foundation Trust. In the UK mergers are first reviewed by the Office of Fair Trading (OFT), and will be referred to the CC for full investigation if the OFT believes that the merger would result in a substantial lessening of competition.

3 Final Report, para. 5.53, page 56: The final report can be found at:

http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/royal-bournemouth-and-christchurch-poole/131017_final_report.pdf.

4 Please refer to the article of this author "Isochrones: Analysis of Local Geographic Markets" available at: http://www.mayerbrown.com/files/Publication/7633e871-05b8-428f-bbcd-cf6d9163bab8/Presentation/PublicationAttachment/c7b45b1f-d4f4-413c-b5aa-b0579c87049f/Isochrones-Desai_Iss2_1108.pdf.

5 OECD, Policy Roundtables, *Competition in Hospital Services*, 2012, DAF/COMP(2012)9.

6 T*echniques for defining markets for private healthcare in the UK, Literature review, Prepared for Office of Fair Trading*, November 2011. Although the report was supposed to address product and geographic definition, the literature review in the report did not discuss product market definition in PH in detail because the reviewers opinion is that "the product market definition will often draw on clinical expertise and judgement, and may also depend on the particular attributes of the competition case being considered." As a result the report focuses on the techniques for geographic market definition.

7 "Can governments do it better? Merger mania and hospital outcomes in the English NHS" by Martine Gaynor, Mauro Laudicella and Carol Propper, Journal of Health Economics 31 (2012) 528-543.

8 *Marry in haste, repent at leisure: when do hospital mergers make strategic sense?*, by Penelope Dash, David Meredith and Paul White, McKinsey, 2012 at: http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CD0QFjAA&url=http%3A%2F%2Fwww.mckinsey.com%2F~%2Fmedia%2FMcKinsey%2520Offices%2FUnited

%2520Kingdom%2FPDFs%2FWhen_hospital_mergers_make_strategic_sense_.ashx&ei=rwsWUrqGBqqk0QXXl4CoCw&usg=AFQjCNFS4QcbHXgGxUNO1m2riSzwB5VNMQ&sig2=QsELCCqQEZ_3H9mvNCweDA&bvm=bv.51156542,d.d2k.

9 *Hospital Quality Competition Under Fixed Prices*, The University of York, Centre for Health Economics, CHE Research Paper 80, November 2012, at: http://www.york.ac.uk/media/che/documents/papers/researchpapers/CHERP80_hospital_quality_competition_fixedprices.pdf.

10 While the reasons are not clear from the public record, it can be noted that for the first public hospital merger investigated by the CC—see footnote 2—very unusually two notices extending the period of the investigation were issued, so extending this investigation from the statutory limit of 24 weeks (approximately 6 months) to approximately 10 months.

11 Substantial lessening of competition.

12 EA 2002, s. 42(1).

13 Id., s. 42(2).

14 Id., s. 58(3).

China Merger Control in 2013

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There were some interesting twists in the public and private enforcement of China's Anti-Monopoly Law (AML) during 2013. In the area of merger control, the Chinese Ministry of Commerce (MOFCOM) published four conditional clearance decisions: Glencore/Xstrata, Marubeni/Gavilon, Baxter/Gambro and MediaTek/MStar. Each decision turns on its own facts, but there are recurring themes:

- MOFCOM is prepared to find market power notwithstanding relatively low market share levels.
- There is a continued preference for the imposition of elaborate and onerous hold-separate arrangements as a condition for clearance.
- MOFCOM has sought commitments to supply certain key products to the Chinese market on favorable terms as a pre-condition to clearance.
- MOFCOM will shy not away from imposing extraterritorial remedies even where the competition economics basis for seeking the commitment might not be that clear cut.
- Coordinated effects theories of harm arise with some regularity in MOFCOM's published decisions and this year's cases offer further examples.

Some of these themes appear driven by industrial policy considerations and indicate that any transaction that involves key industries—food and agriculture in Marubeni/Gavilon, minerals and ores in Glencore/Xstrata, important inputs for Chinese manufacturers in MediaTek/MStar—will be scrutinized closely and regulated with an eye toward broader strategic interests. By contrast, Baxter/Gambro is something of an anomaly in so far as political considerations were not in issue.

We explore below these four cases in detail and consider the implications for MOFCOM's future practice.

Glencore/Xstrata

Following a lengthy review lasting the best part of a year, on April 16, 2013, MOFCOM gave a conditional green light to the acquisition of Xstrata by Glencore. The long review period is not the only way in which the decision stands out. Particularly striking is MOFCOM's decision to seek an extraterritorial divestiture in circumstances where the competition arguments that might justify this decision appear to be borderline.

Also striking is the fact that the regulator, for the first time, published a detailed scheme of the remedial commitments it accepted from the parties as a pre-condition to clearance. This document offers a valuable insight into MOFCOM's practice and merits careful consideration. It is also a further indication of MOFCOM's ongoing and developing commitment to a more transparent process.

Although neither Glencore nor Xstrata own or operate productive assets in the relevant markets in China, MOFCOM took great interest in the transaction, focusing on the importance of China as a major market for the parties and China's reliance on imports of raw materials of central importance to the wider Chinese economy. Explaining that import volumes of copper, zinc and lead concentrate accounted for 68.5, 28.7 and 27.3 percent, respectively, of total supplies on the Chinese market in 2011, and that the parties had relatively high market shares in the production and supply of these products globally and in China, MOFCOM focused its review on these markets and ultimately concluded that the acquisition may have the effect of eliminating or restricting competition in them.

That said, the analysis of the parties' market power in the production and supply of copper concentrates suggests that MOFCOM is willing to find market power at what might otherwise be considered moderate market share levels. The regulator explained that Glencore and Xstrata are among the world's leading producers and suppliers of copper concentrate and that the global market shares of Glencore and Xstrata for the production of copper concentrate were 1.5 and 6.1 percent, respectively, in 2011, with a combined share of 7.6 percent, collectively ranking third in the world. Further, the global market shares of the parties in 2011 with respect to the supply of copper concentrate were 5.3 and 4 percent, respectively, with a combined share of 9.3 percent, ranking first in the world. As regards the market shares of Glencore and Xstrata for the supply of copper in China itself, these were 9 and 3.1 percent for 2011, giving a combined share of 12.1 percent—a leading position on the market.

While the published decision does elaborate other reasons for concluding the parties would have market power post-merger in the copper concentrate market (vertical integration and foreclosure concerns, barriers to entry), it is worth noting that the market share levels discussed above are all well below the 25 percent figure used by, for example, the European Commission to establish a threshold below which an absence of restrictive effects can be presumed. Whether MOFCOM will always be willing to find market power at such levels is not clear. Arguably, the central issue for the regulator in the case was an understandable concern that China was uniquely dependent on overseas supplies of a critical commodity.

The analysis of competition concerns in the markets for zinc and lead concentrate is, in many respects, comparable to the analysis for copper, albeit that MOFCOM noted that China is less dependent on imports as indicated above. MOFCOM therefore took the view that softer behavioral commitments would suffice in these markets.

The most notable of the restrictive conditions imposed—and likely the cause of the protracted review as the regulator and the parties sought to agree an acceptable compromise—is the required divestiture by September 2014 of Xstrata's Las Bambas copper mine in Peru at a price not lower than the higher of the fair market value of the mine or the sum of all costs incurred in developing it. The purchaser must be approved by MOFCOM, though Glencore has undertaken to use its best efforts to submit the details of all potential buyers of Las Bambas to MOFCOM by August 31, 2014. Whether this means MOFCOM would then select a buyer is not entirely clear.

If Glencore fails to comply with the structural remedy and sell Las Bambas within the required time, the remedy scheme provides that Glencore must submit a proposal to MOFCOM for the appointment of a divestiture trustee empowered to sell, without a reserve price, Glencore's interest in one of a number of alternative copper mining projects in Latin America or Southeast Asia as might be specified by MOFCOM.

In addition to the structural remedy, MOFCOM sought conduct remedies: behavioral conditions were imposed relating to the pricing and volumes of copper, zinc and lead concentrates supplied to Chinese customers. For a period of eight years, Glencore agreed to supply the Chinese market with 900,000 tons of copper concentrate annually at a regulated price—although the minimum volume is subject to adjustment in line with Glencore's actual levels of production. In the case of supplies of zinc and lead concentrates, Glencore agreed that during the eight-year supply commitment period, its offer conditions would be "fair, reasonable, and consistent with the then prevailing terms used in the international market."

Marubeni/Gavilon

MOFCOM published its conditional approval of Marubeni's acquisition of Gavilon Holdings hot on the heels of the decision in Glencore/Xstrata. The US$5.6 billion grain deal between one of Japan's largest trading companies and the third-largest North American grain company took just under one year for MOFCOM to clear.

First notified by the parties in June 2012, the notification was withdrawn and resubmitted in January 2013 at the end of a Phase III review and after an initial remedies proposal had been rejected. The transaction was ultimately cleared several days after the parties agreed to operate Marubeni's and Gavilon's China soybean export businesses through separate and independent legal entities backed up by firewall mechanisms to safeguard against the exchange of competitively sensitive information. The final remedies scheme includes the following elements:

- Marubeni and Gavilon will set up two independent legal entities for the purpose of exporting and selling soybeans on the China market.
- Marubeni's soybean subsidiary and Gavilon's soybean subsidiary will maintain structural and operational independence with respect to personnel, sourcing, marketing, sales and pricing functions. Post-completion, Marubeni's soybean subsidiary will not source soybeans from Gavilon's US assets except on an arm's-length basis.

Extensive hold-separate remedies of this kind are not unusual in the China context, and MOFCOM imposed similar arrangements in Western Digital/ Hitachi in 2012. What is telling, is not so much the remedies as such but more the basis for seeking them in the first place. MOFCOM's decision rehearses the key considerations:

- China is the world's largest importer of soybeans. In 2012, China's imported volume of soybeans accounted for 60 percent by volume of total worldwide soybean trade, and 80 percent of China's domestic supply.
- China imported 58.38 million tons of soybeans in 2012, implying a total domestic market of 72.975 million tons (MOFCOM makes no reference however to total market size as it defines the relevant market as a market for imports). [1]
- Marubeni shipped 10.5 million tons of soybeans to China in 2012, implying an approximate market share of 14 percent—or 18 percent if the relevant market is defined by reference to imports alone as in the MOFCOM decision.2 Marubeni ranked first among suppliers of imported soybeans in China.

- Gavilon's global soybean sales in 2012 amounted to 5.1 million tons. This seems to translate into a global market share of approximately 5 percent.3 MOFCOM does not provide any market share for Gavilon in China but the figures provided in the decision allow one to determine that its share would be less that 1 percent.4
- While noting that the supply of soybeans in China was highly dependent on imports (80 percent of all supplies were imported in 2012 as mentioned above), MOFCOM explained that the downstream domestic China market for soybean crushing was highly fragmented and characterized by small scale production with weak countervailing bargaining power.

Overall, the key consideration appears to have been that the deal would significantly boost Marubeni's access to global soybean resources through the acquisition of Gavilon's capacity for soybean origination, storage and logistics in North America, thus enhancing Marubeni's ability to import soybeans into China. This would result in what MOFCOM terms a "materially strengthening" of Marubeni's "control" over the import market for soybeans.

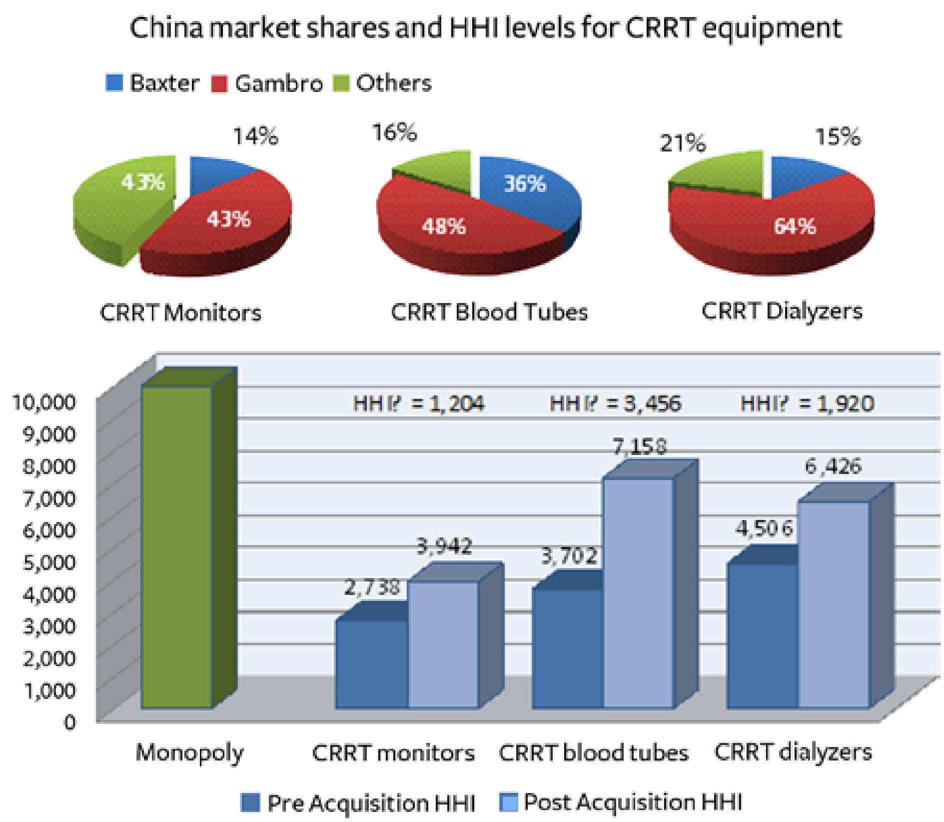
Nonetheless, a more orthodox assessment of the facts might lead one to question whether the parties have any particular level of market power on the relevant market for soybeans. In this respect, it is notable that MOFCOM appears not to have considered in any detail the degree of competitive constraint provided by Marubeni's rivals or the ability of competitors to expand in response to attempts by the merged firm to increase prices and/or lower output. And, as indicated above, it is striking that MOFCOM chose to define the relevant market as a market for *imports* into China thus, by implication, taking the view that domestic supplies were somehow not relevant to the assessment. Whatever the rationale for such an approach—the decision is silent on the point—the effect would be to overstate the parties' market position, albeit that on the facts of the case, not by very much.

Baxter/Gambro

Baxter/Gambro was conditionally approved on August 8, 2013, after MOFCOM opened a so-called "Phase III" review—an agreed extension to Phase II.

MOFCOM focused its competition assessment on the relevant global and domestic China markets for continuous renal replacement therapy (CRRT) equipment and related consumables (collectively, the markets for CRRT equipment) and haemodialysis (HD) equipment. MOFCOM concluded that the transaction would likely eliminate or restrict competition in these markets and specifically, for MOFCOM's purposes, the China market for the relevant products.

The pie charts below show the parties' respective market shares in the CRRT China markets as disclosed by MOFCOM in its decision. Interestingly, MOFCOM also offers a detailed assessment of concentration levels pre- and post-transaction using the Herfindahl-Hirschmann Index (HHI).5 MOFCOM's findings in this respect are shown here in chart form.



In relation to CRRT equipment, MOFCOM found that the transaction would significantly increase concentration levels in the relevant markets (the HHI "delta" or difference between the HHI levels pre- and post-acquisition serves as an indicator or proxy for the change in concentration levels brought about by the merger) and eliminate Baxter's closest competitor, resulting in high combined market shares held by the merged firm post acquisition and affording it what MOFCOM regarded as a "dominant position" in the China markets for CRRT equipment.

With respect to HD equipment, MOFCOM concluded that the transaction would likely result in "coordinated effects" in the relevant markets in China, with the two main competitors—the merged entity and a third party, Nipro Medical Corporation—holding a combined 48 percent market share. Although the "increment" in the merged firm's market share was a modest 3 percent (according to MOFCOM Gambro's market share was 19 percent, while Baxter's was 3 percent), the key consideration would appear to have been the existence of an agreement between Baxter and Nipro for the production of HD products. MOFCOM was concerned that this agreement created a risk that competitively sensitive information would be exchanged on such matters as production costs and quantities. The agreement would "facilitate the mutual coordination" of the two key players on the China HD market, according to MOFCOM. On this point, it might be noted that MOFCOM appears generally more open to deploying a coordinated effects theory of harm as compared with authorities elsewhere. That said, the existence of structural links between players in a market is generally recognized as an important consideration when assessing the likelihood of coordinated effects.

In light of its concerns, MOFCOM approved the transaction subject to the following:

- The divestiture of Baxter's global CRRT business; and
- The discontinuation of the Baxter-Nipro agreement for the production of hemodialyzers in so far as it related to China.

Other authorities, notably the EU Commission and the Australian Competition and Consumer Commission, accepted a similar remedy in relation to CRRT equipment. By contrast, the EU Commission noted in its press release announcing it had cleared the transaction that it "found that Baxter and Gambro are not particularly close competitors in HD and will continue to face, after the merger, significant competition from a range of dynamic market participants." Different regulators reaching different conclusions is, of course, an inevitable feature of global merger control.

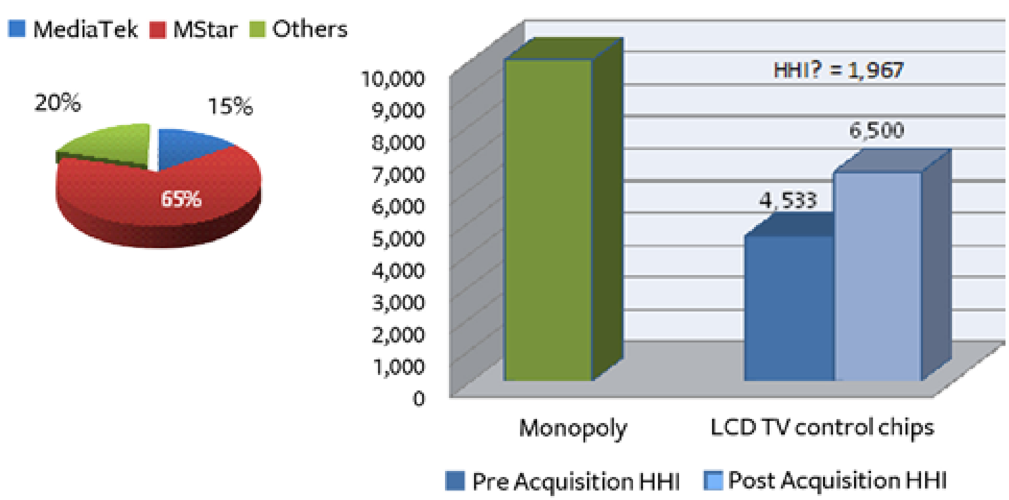
MediaTek/MStar

MediaTek/MStar was first filed with MOFCOM on July 6, 2012. Following a number of rounds of unsuccessful negotiations between the parties and MOFCOM over the scope of a possible remedies package, the filing was eventually cleared on August 26, 2013.

MOFCOM noted that both merging parties are mainly engaged in the design and manufacture of integrated circuit chips for multimedia display and wireless communications devices. After concluding that the transaction would not likely have any anticompetitive effects on the market for mobile phone baseband chips, MOFCOM focused on the market for LCD TV control chips. The published decision is equivocal as to whether the geographic scope of this market is global or national, but MOFCOM's main concern was clearly the China market which, in any event, had its own special features in MOFCOM's view.

The pie chart below shows the parties' respective market shares in the relevant China market as set out in MOFCOM's decision. As in Baxter/Gambro, MOFCOM offered a detailed assessment of concentration levels using the HHI system of indicators. MOFCOM's findings in this respect are again shown here in chart form.

China market shares and HHI levels for LCD TV control chips



MOFCOM considered the relevant Chinese market for LCD TV control chips to be highly concentrated before the merger and noted that the transaction would "obviously" change the structure of the market. In MOFCOM's view, the acquisition would eliminate MediaTek's closest competitor and remaining suppliers, and the threat of new entry, would not constitute an effective competitive restraint post merger. MOFCOM concluded that the merged entity would become the "dominant" player in China with a market share of 80 percent.

In view of these concerns, MOFCOM imposed a rather striking set of behavioral remedies:

- MStar's LCD TV control chip business (Morningstar) must be maintained as an "independent competitor" on the market;
- MediaTek's exercise of its shareholder rights in Morningstar are to be strictly limited and subject to prior approval by MOFCOM with the exception of rights to receive dividends and information necessary for producing consolidated financial statements;
- Directors of Morningstar may only be appointed/removed with the approval of MOFCOM;
- MediaTek and Morningstar must maintain their R&D investments at no less than pre-acquisition levels;
- MediaTek and Morningstar are prohibited from exchanging competitively sensitive information and using customers as conduits for the exchange of such information. Board members and senior executives who breach this obligation may be dismissed;
- Cooperation between MediaTek and Morningstar is to be subject to prior approval;
- Certain customary pre-acquisition practices regarding the supply of LCD TV control chips and after-sales service levels must be maintained post merger;
- Should MediaTek and/or Morningstar merge in the future with another party active in the LCD TV control chip market, they must seek prior approval from MOFCOM. This applies regardless of the turnover of the undertaking concerned; and
- MediaTek and Morningstar must comply with certain arrangements intended to control the prices of LCD TV control chips and related products sold on the China market. In particular, prices in China must not be higher than the prices of similar products sold by MediaTek and Morningstar outside China.

Looking at these remedies, the obvious question might be why MOFCOM would choose such a structure over a divestiture, which would seem equally capable of addressing the competition concerns identified while placing less of a burden on MOFCOM in terms of monitoring. On the other hand, a straightforward divestiture would not have afforded MOFCOM the leverage it acquired over LCD TV control chip pricing in China in view of the pricing commitment described above.

Conclusion

While a review of these recent cases clearly highlights the importance of industrial policy in a MOFCOM review, conditionally cleared cases are the exception rather than the rule. Such decisions make up a very small percentage of the cases filed with MOFCOM: approximately 97 percent of filings are cleared unconditionally. Standard competition considerations are therefore the prime concern although industrial policy could well trump this in a given case. ◆

Endnotes

1 MOFCOM does not in fact give any market share percentages for soybeans in its decision. It explains however that China imported 58.38 million tons of soybeans in 2012 and that this accounted for 80 percent of China's domestic supply. Accordingly China's total market size would be in the region of 72.975 million tons. Assuming Marubeni shipped 10.5 million tons of soybeans to China in 2012

(MOFCOM's figure), this implies a market share of 14 percent of all domestic supply or 18 percent if the relevant market is defined by reference to imports alone as MOFCOM does.

2 See footnote 1 above.

3 MOFCOM advises that in 2012, China's imported volume of soybeans accounted for 60 percent by volume of total worldwide soybean trade. As China imported 58.38 million tons of soybeans in 2012, this would suggest the global market amounted to 97.3 million tons. If Gavilon's global soybean sales in 2012 amounted to 5.1 million tons (MOFCOM's figure), this translates into a global market share of approximately 5 percent.

4 MOFCOM advises that in China Gavilon is active in the trading of "bulk agricultural produce such as yellow corn, soybeans, soy meal, and feed and food ingredients". MOFCOM further notes that in 2012, Gavilon exported to China a total quantity of about 400,000 tons of bulk agricultural produce. Even assuming this entire volume was constituted by soybeans (which it would not be), this translates into a market share of less than 1 percent even where the relevant market is defined solely by reference to imports.

5 The Herfindahl-Hirschmann Index measures concentration levels in a given market by summing the squares of the individual market shares of all the firms in the market.

China's Security Review System for Foreign Investment: Where Do We Stand?

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Almost three years have passed since China formally established its security review system with regard to mergers and acquisitions of domestic enterprises by foreign investors ("Security Review System"). The regime has had a relatively low profile when compared with the acceleration in China's Anti-Monopoly Law ("AML")-related enforcement activity and procedural developments over the same period.

The very broad scope and criteria for review, and the lack of significant new developments since the Ministry of Commerce ("MOFCOM") finalized its procedural rules for the regime,[1] mean that there remains the risk that, in seeking to ensure compliance with these rules, local bureaus could broadly interpret what may be a "sensitive" sector or investment and thereby cause further delays in relation to foreign investment deals (by referring such transactions to MOFCOM and suspending their own reviews). Three years on, the lack of transparency and the uncertainties created by the regime are still issues to be addressed by Chinese authorities, and foreign parties looking to invest in China will have to continue carefully navigating this process for the foreseeable future.

This article summarizes the key aspects of the regime, including its background, scope and relevant procedures and rules to date.

Relevant Legislation and Regulations

On 3 February 2011, the State Council published the *Circular of the General Office of the State Council on Establishment of a Security Review System Regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* ("Circular 6"), which formally commenced the Security Review System and became effective on 5 March 2011.

On 4 March 2011, MOFCOM promulgated the *Interim Rules of the Ministry of Commerce on Issues Relating to Implementation of Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*. After a period of consultation and practice, MOFCOM replaced the interim rules with the *Rules of the Ministry of Commerce on Implementation of Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* ("MOFCOM Rules") on 25 August 2011.

Together, Circular 6 and the MOFCOM Rules provide for the substance of the Security Review System, detailing its scope, relevant considerations, decision-making procedures, enforcement powers and other relevant matters.

China's security-related review mechanism regarding takeovers of domestic enterprises by foreign investors was introduced long before 2011. For example, *Article 19 of the Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (2003), provided for national economic security as a consideration in the review of foreign M&A deals in China. Similar subsequent provisions—such as Article 12 of the *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (2009)—have continued to provide for national economic security as a relevant consideration by MOFCOM.

National security screening requirements were codified in Chinese national legislation for the first time in August 2007 through the inclusion of Article 31 in the AML, which stipulates that M&A of domestic enterprises by foreign investors where national security is affected should undergo national security review "according to relevant provisions" ("Security Review"). However, no further provisions or regulations were enacted to provide details for the process as referenced in Article 31 during the period 2007-2010, until Circular 6 and the MOFCOM Rules were issued.

Transactions Covered by the Security Review System

According to Circular 6, a transaction falls within the scope of Security Review if the following two criteria are satisfied. In practice, the broad and non-exhaustive wording of the criteria (especially in terms of relevant sectors) will often raise doubts as to whether a particular transaction is caught by the Security Review System, in which case foreign investors may consider consulting with MOFCOM to seek clarity around this issue.

CROSS-BORDER M&A TRANSACTIONS INVOLVING FOREIGN INVESTORS

A transaction may be the subject of a Security Review if it is a "merger/acquisition of a domestic enterprise by foreign investor(s)" for the purposes of the Security Review System, which includes the following types:

- Foreign investment in a domestic enterprise that is a non-foreign invested enterprise ("-FIE") (in the form of acquiring equity or subscribing to the capital increase), thereby transforming it into an FIE;
- Acquisition of Chinese shareholder-held equity in an FIE, or subscribing to the capital increase of an FIE;
- Acquisition of assets or equity from a domestic enterprise (either a non-FIE or an FIE) through an FIE; or
- Acquisition of assets of a domestic enterprise (either a non-FIE or an FIE) and operating such assets through a newly established FIE.

RELEVANT SECTORS

The second criterion determining whether a transaction will be reviewed under the regime is whether it involves a merger/acquisition of a domestic enterprise active in certain sectors in China, where the transaction satisfies either of the descriptions below:

- The transaction involves an "acquisition of" national defense enterprises, such as military industrial enterprises and supporting enterprises for the military industry, enterprises in the vicinity of key or sensitive military installations, and other entities in relation to national defense security ("Sector A" enterprises); or

- The transaction involves foreign investor(s) "acquiring actual control of" domestic enterprises that have a bearing on national security in such areas as important agricultural products, vital energy and resources, essential infrastructure, crucial transportation services, key technologies, and major equipment manufacturing ("Sector B" enterprises).

On a literal reading of Circular 6, it would appear that the Security Review System sets a lower threshold for foreign investment transactions relating to Sector A enterprises (those connected with military and national defense interests), requiring only an "acquisition," as opposed to "acquiring actual control." However, the description of Sector B enterprises (those that have a bearing on national security) is extremely broad, and there remain uncertainties and contradictory views held by various government departments as to what this means in practice.

What constitutes "actual control"?

The term "acquiring actual control" is defined in Circular 6 as "becoming a controlling shareholder or an actual controller of a domestic enterprise through merger/acquisition." In addition, Circular 6 sets out certain situations of "acquiring actual control" as follows:

A foreign investor, together with its parent holding company and/or its holding subsidiary, holds 50% or more of the total shares in a relevant domestic enterprise following the relevant transaction;

- Several foreign investors hold an aggregate of 50% or more of the total shares in a relevant domestic enterprise following the relevant transaction;
- Even though the foreign investor does not hold 50% or more of the total shares following the transaction, the voting rights attached to the shares held by such foreign investor in a relevant domestic enterprise are sufficient to have a major influence on the resolutions of any shareholder meeting, annual general meeting or board meeting of that enterprise; or
- Other circumstances exist that may lead to the transfer of the actual control of matters such as business decision-making, finance, personnel and technology of the domestic enterprise to the foreign investor.

What are Sector B enterprises?

The table on the following page lists relevant documents issued by various authorities that provide some guidance on the Circular 6 criteria by specifying the types of enterprises that have a bearing on national security.

RELEASE DATE AUTHORITY	DOCUMENT NAME	SECTOR/ENTERPRISE
17 May 2011 Ministry of Agriculture	The 12th Five-Year Development Plan for Agricultural Products Processing Industry	Key enterprises in the processing industry for important agricultural products, such as grains and oil crops
17 Aug 2011 Ministry of Industry and Information Technology	Policy on the Development of Agricultural Machinery Industry	Key manufacturing enterprises of agricultural machinery

Continued ▼

RELEASE DATE AUTHORITY	DOCUMENT NAME	SECTOR/ENTERPRISE
13 Dec 2011 General Office of the State Council	Opinions of the General Office of the State Council on Strengthening the Construction of Circulation System for Fresh Agricultural Products	Large-scale wholesale markets of agricultural products
6 Mar 2012 State Council	Opinions of the State Council on Supporting the Development of Leading Enterprises for Agricultural Industrialization	Leading agricultural enterprises
26 Dec 2012 General Office of the State Council	National Development Plan on Modern Crop Seed Industry (2012-2020)	Seed enterprises
2 Apr 2013 Department of Commerce of Jiangsu Province	Notice on Further Strengthening the Coordination and Implementation of Foreign M&A Security Review System	Industries listed in the relevant catalogues of National Development and Reform Commission ("NDRC")[2] Industries with relevant technologies and products listed in the *Catalogue of Key Technologies and Products of which China Should Hold Independent IPR*[3] Industries internally listed for security review within MOFCOM[4]

Even drawing on the guidance provided in these documents, the Circular 6 criteria relating to Sector B enterprises remains very broad. Article 4 of the MOFCOM Rules provides that foreign investors can apply to MOFCOM for consultation on the relevant "procedural" issues of the Security Review System. However, Article 4 also makes it clear that such consultation has no binding and legal effect. Foreign investors may obtain a legally binding answer from MOFCOM only by making a formal application to MOFCOM, which will then entail additional paper work and time. Parties may choose to also consult MOFCOM on "substantial" issues (such as whether a transaction shall undergo Security Review).

Security Review Assessment

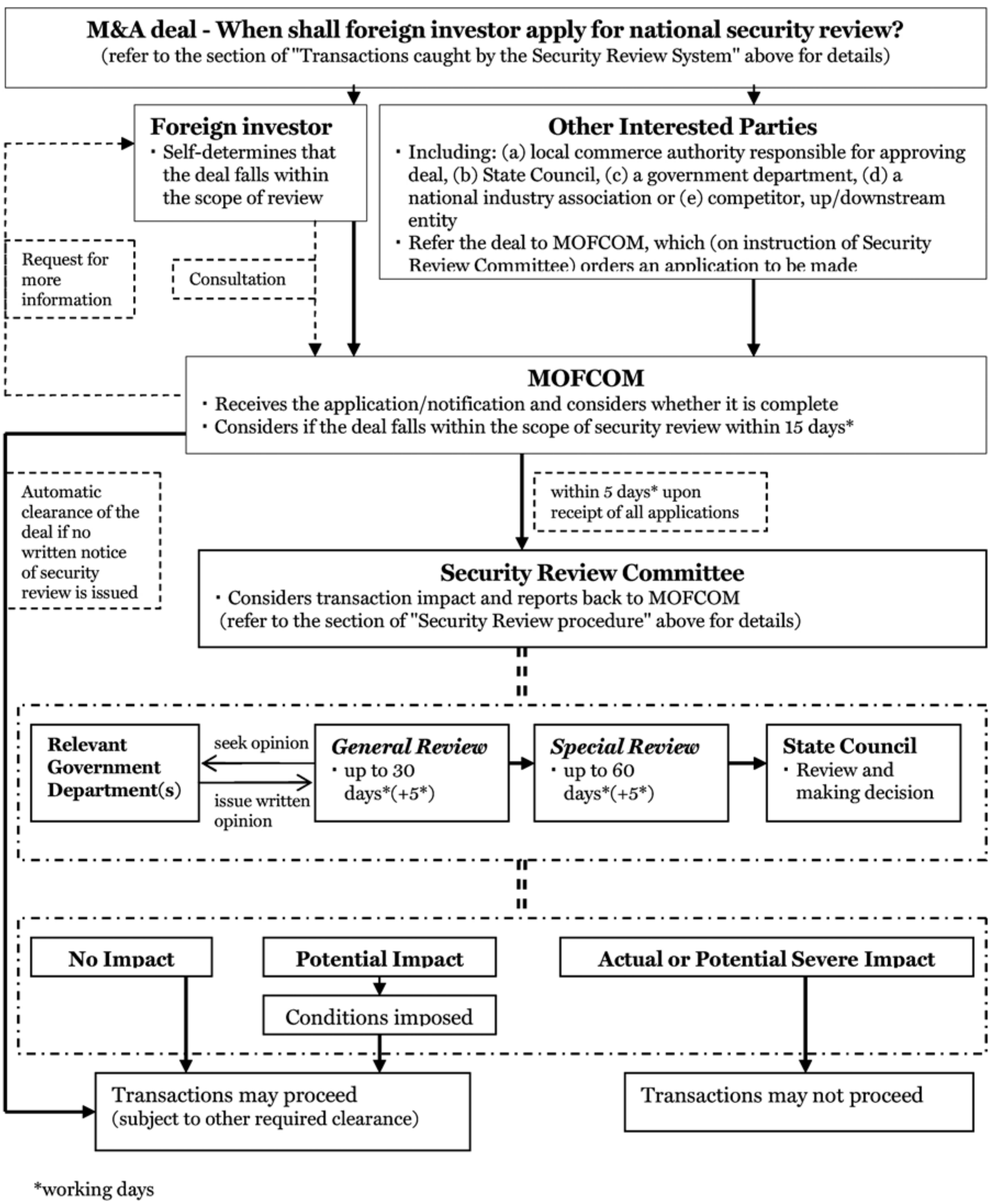
Under Circular 6, a Security Review will involve assessing whether a foreign investment transaction will impact any of the following:

- National defense security (and, in particular, domestic production capacity, domestic services provision capacity or relevant equipment and facilities that are required for national defense);
- The stability of the national economy;
- Basic social life order; and
- The capacity of indigenous R&D of key technologies related to national security.

These are obviously also very broad review criteria, and foreign investors are no doubt concerned about the breadth of discretion it affords Chinese agencies to identify security concerns in respect of the China-focused transactions.

Security Review Procedure

The flow chart below summarizes the key aspects of the Security Review process under Circular 6 and the MOFCOM Rules.



RELEVANT AGENCIES

Circular 6 established a new interministerial joint committee ("Security Review Committee") to conduct Security Review work. The Security Review Committee operates under the overall leadership of the State Council, with the NDRC and MOFCOM taking the lead in carrying out Security Review in association with relevant departments, depending on the specific industries and sectors involved in the foreign investment transaction.

MOFCOM, which effectively acts as the gatekeeper for referring deals to the Security Review Committee, is responsible for reviewing formal applications from foreign investors for completeness and for determining whether the notified transactions indeed fall within the scope of Security Review. MOFCOM will then submit the qualified applications to the Security Review Committee for substantial review.

The Security Review Committee is charged with analyzing the impact of notified transactions on national security and making decisions.

APPLICATION TO MOFCOM

Foreign investors must apply to MOFCOM for Security Review of their M&A transactions in the following three circumstances:

- Where, after a self-assessment, foreign investors believe their transactions fall within the scope of Security Review;
- Where a local MOFCOM requires foreign investors to apply for Security Review (the local MOFCOM will suspend its own review process); and
- Where government departments, national industry associations, competitors and upstream/downstream enterprises suggest that certain transactions should be subject to Security Review, and both MOFCOM and the Security Review Committee take the same view.

Where two or more foreign investors jointly engage in an M&A transaction, they can either jointly make the application or appoint one of the foreign investors to do so.

In considering whether a transaction falls within the scope of Security Review, MOFCOM will look at the substance and actual impact of the arrangements. The MOFCOM Rules clearly state that foreign investors shall not circumvent Security Review by means of nominee holding structures, trust arrangements, multilayer investment and reinvestment structures, leasing or lending arrangements, contractual control mechanisms, overseas transactions or any other means. It should be noted also that guidelines relating to the security review process issued by the Department of Foreign Investment Administration of MOFCOM require that parties submit a written guarantee that they have not sought to avoid the Security Review process, such as by utilizing an arrangement of the type mentioned.

Once foreign investors decide to make a formal application to MOFCOM, they shall submit an application form and enclose it with a significant volume of other materials as required by the MOFCOM Rules and relevant application guide. If the application materials are complete and meet the statutory requirements, MOFCOM will inform the applicant in writing that the application is accepted. Otherwise, the applicant will be required to furnish the necessary further information.

REFERRALS BY GOVERNMENT DEPARTMENTS AND THIRD PARTIES TO MOFCOM

New wording was added to pre-existing provisions empowering government departments, industry associations and industry participants to alert the Chinese authorities to deals that they consider should be subject to security review. This wording states that MOFCOM may "require relevant explanations" from entities that make such referrals. While this may simply reflect the ability of MOFCOM to liaise with the relevant entities to obtain necessary details, it may also reflect concern about the potential for the referral process to be misused by (in particular) competitors of the parties proposing to enter into a relevant M&A deal—and to empower MOFCOM to make inquiries into whether a referral is made simply in an attempt to cause difficulties and delay for transactions.

TIMING

MOFCOM shall, within 15 working days from the date of accepting the application, form a view on whether it considers the notified transaction should be subject to Security Review and, if yes, inform the applicant in writing. MOFCOM then shall refer the application to the Security Review Committee within 5 working days. An applicant shall not implement its transaction during this time but can proceed if it does not receive any notice from MOFCOM after the 15-day period expires.

If a transaction is referred to it for review, the Security Review Committee will undertake a preliminary review ("General Review") of the transaction for a period of up to 30 working days, during which time it will consult with interested government departments.

If it is determined during this General Review that the transaction does not raise national security concerns, the Security Review Committee will inform MOFCOM of this decision in writing (and MOFCOM then has 5 further working days to report the decision to the transaction parties).

If, however, any of the government departments that are consulted consider that the transaction does raise national security concerns, a further review will take place ("Special Review").

According to Circular 6, Special Review may take up to 60 working days, at the end of which the Security Review Committee will deliver to MOFCOM a decision in writing (which MOFCOM will inform the applicant within 5 working days). However, if there is significant disagreement among members of the Security Review Committee as to whether the transaction does give rise to Security Review issues, the transaction will be referred to the State Council for further consideration. No time limit for State Council consideration is provided under Circular 6.

After MOFCOM has referred the application to the Security Review Committee, if the applicant amends the application materials, cancels the notified transaction, or supplements or amends materials as required by the Security Review Committee, it shall submit the relevant materials to MOFCOM, and MOFCOM shall refer these materials to the Security Review Committee within 5 working days.

Decisions/Remedies

The Security Review Committee will, after substantial review of a notified transaction, provide a decision in writing to MOFCOM, which will then notify the applicant in writing within 5 working days.

If the Security Review Committee decides that the notified transaction has no impact on national security, the transaction parties may proceed (subject to other required foreign investment approval and registration procedures).

If the transaction is found to have potential impact on national security and such transaction has not been implemented, the transaction parties will be required to suspend the transaction. Without adjusting the transaction, amending the application materials and going through Security Review, the transaction parties will not be allowed to implement the transaction.

However, if the Security Review Committee considers that the transaction has an actual or potential severe adverse impact on national security, it may request that MOFCOM coordinate with other relevant departments to either terminate the transaction or to take effective measures such as transferring relevant equity or assets to eliminate the impact of the transaction on China's national security.

Moving Forward—Scope for Greater Clarity and Certainty

China's Security Review System, which operates separately from merger review under the AML (although there are references to security review in the AML) and other foreign investment approval processes, remains an additional area in which foreign parties must tread carefully when considering investing in China. The interaction of these different review systems interact, particularly through the Security Review referral process, will likely result in gradual developments of law and procedure as China continues its efforts to keep these regimes consistent and unified (such as the formal introduction in the MOFCOM Rules of a confidentiality obligation similar to that in the AML system, requiring MOFCOM and other entities involved in the Security Review process to keep state secrets, trade secrets, and other related secrets confidential).

MOFCOM Rules failed to clarify a number of important issues relating to the Security Review process, including how parties can in practice self-assess deals for any potential bearing on China's national security when the Chinese authorities have so far only published a very broadly worded and non-exhaustive list of sectors that may be considered "sensitive" in this respect (and they do not publish details on transactions reviewed by the Security Review Committee). Until further guidance is issued, given the inherent uncertainties that still remain in the Security Review System, it is essential for foreign investors to consider at an early stage whether there is a need to engage with local commerce authorities and to consult with MOFCOM to obtain as much clarity and certainty as possible so as to mitigate risk in their transactions.

Apart from dealing with the difficulties of self-assessment and securing other required approvals in a timely manner, foreign investors need to keep mindful of the changing scope of Security Review along with China's continuing economic development and industry focus. These investors also need to be aware of, and sensitive to, the relevant government policies and big picture issues concerning the industries in which they are considering investing. ◆

Endnotes

1 China's new state security committee, announced at the Third Plenum of the 18th Communist Party of China Central Committee in November 2013, will not likely be directly relevant to the Security Review System, given that experts in China have commented that it is modelled on the US National Security Council as a high-level organ under the direct leadership of the President to handle major and strategic matters in relation to national security and foreign policy.

2 Such catalogues may include the *Catalogue for Guidance of Foreign Investment Industries* (2011), the *Catalogue for Guidance of Industrial Structure Adjustment* (2011, partly amended in 2013) and *Catalogue for Guidance of Key Products and Services in Strategic Emerging Industries* (2013).

3 (GuoKeFaJiZi [2006] No. 540) – available at http://www.zjkj.gov.cn/kjm/fo/toPIDetail.do?id=PI3192.

4 An example of such a list is available at http://zhuzhou.hninvest.gov.cn/tzzn/381334.htm. However, the industry codes used in this list (security review industry table) are based on the old 2002 version of the Classification of National Economic Industries, suggesting that this list may have since been updated by MOFCOM.

The Uncertain Reach of Section 5 of the Federal Trade Commission Act

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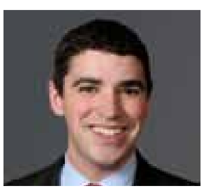

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Compliance with US antitrust laws requires firms to consider not only conduct that falls within the scope of the Sherman Act and the Clayton Act, but also conduct that may violate the Federal Trade Commission Act (the "Act"), particularly Section 5. This task is complicated by the fact that the outer scope of Section 5 remains largely undefined, leading to uncertainty as to what conduct is permissible and impermissible. In the absence of further legislative or judicial oversight, it is unclear just how far Section 5 reaches.

Established almost a century ago, the Federal Trade Commission ("FTC") shares enforcement responsibilities for US competition laws with the Antitrust Division of the Department of Justice. The FTC derives its enforcement powers from the Federal Trade Commission Act and the Clayton Act,[1] and its enforcement mission is to halt conduct deemed harmful to competition, including practices barred by the Sherman Act, such as price fixing, bid rigging, customer allocation and other per se antitrust violations.[2] Although not expressly authorized to enforce the Sherman Act, the FTC reaches such conduct through Section 5, which states that "[u]nfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful."[3] But a question going back to when the Act first became law still remains unanswered: beyond conduct that is already prohibited by the Sherman Act and the Clayton Act, precisely what falls within Section 5's prohibition on "unfair methods of competition?"

There are some who have argued that Section 5 is "coterminous" with the Sherman Act and the Clayton Act—a "vehicle by which the [FTC] challenges" traditional antitrust violations.[4] Yet it seems clear that Congress intended something else. The legislative history shows that Congress purposefully passed a vague statute to avoid the "endless task" of legislatively drawing the line between fair and unfair practices in all cases and intended that the reach of Section 5 be developed over time.[5] As the Supreme Court observed, "[i]t would not have been a difficult feat of draftsmanship to have restricted the operation of [Section 5] to those methods of competition in interstate commerce which are forbidden at common law or which are likely to grow into violations of the Sherman Act, if that had been the purpose of the legislation."[6]

The more widely accepted argument is that Section 5 "was intended from its inception to reach conduct that violates not only the antitrust laws, but also the policies that those laws were intended to promote"[7] and that Congress "adopted a phrase which … does not admit of precise definition, [because] the meaning and application [would] be arrived at by … the gradual process of judicial inclusion and exclusion."[8] However, while the Sherman Act's equally vague ban on any "contract, combination … or conspiracy, in restraint of trade" now incorporates a vast body of case law interpreting its meaning, Section 5 jurisprudence did not develop the same way.

Sperry & Hutchinson was the Supreme Court's last comprehensive analysis of the FTC's Section 5 powers. That opinion, however, is 40 years old and has been described as controversial.[9] In *Sperry*, the FTC entered a cease-and-desist order against Sperry & Hutchinson Co. (S&H) for attempting to "suppress the operation of trading stamp exchanges and other 'free and open' redemption of stamps."[10] The Fifth Circuit vacated the order, finding that S&H's conduct had not "violated either the letter or the spirit of the antitrust laws," and thus the order exceeded the scope of Section 5.[11] Without reaching the question of whether S&H's conduct did, in fact, violate the letter or spirit of existing antitrust laws, the Supreme Court found that Section 5 empowers the FTC to define and proscribe unfair competitive practices, even if not an infringement of other antitrust laws.[12] The Supreme Court concluded that the FTC "does not arrogate excessive power to itself if, in measuring a practice against the elusive, but congressionally mandated standard of fairness, it, like a court of equity, considers public values beyond simply those enshrined in the letter or encompassed in the spirit of the antitrust laws."[13]

Analogizing the FTC's powers to those of a court of equity signals the Supreme Court's view, at the time, that Section 5 powers were quite broad, perhaps not even constrained by precedent. But circuit courts later found that Section 5 has its limits. For example, in *E.I. du Pont de Nemours & Co. v. F.T.C.*,[14] although conceding that a definition of "unfair" methods of competition is "elusive," the court vacated the FTC's finding that competing firms in an oligopoly violated Section 5 by unilaterally and non-collusively adopting practices that included: (1) the sale of a product by all four firms at a delivered price, which included transportation costs; (2) providing "extra" advance notice of price increases; and (3) the use of "most favored nation" clauses in contracts with customers. The court explained its view on the outer reach of Section 5, holding that, when a practice is not "collusive, coercive, predatory or exclusionary in character, the standards for determining whether it is 'unfair' … must be formulated to discriminate between normally acceptable business behavior and conduct that is unreasonable or unacceptable."[15] Otherwise the "door would be open to arbitrary or capricious administration" of Section 5, because "the FTC could, whenever it believed that an industry was not achieving its maximum competitive potential, ban certain practices in the hope that its action would increase competition."[16]

The last time a circuit court evaluated a pure Section 5 claim was 1992, and the standards for determining what is "unfair" continue to remain obscure.[17] Recognizing this obscurity, Commissioner Joshua Wright recently advocated that the FTC should focus its Section 5 efforts on "plainly anticompetitive conduct"—meaning a practice that "(1) harms or is likely to harm competition significantly and that (2) lacks cognizable efficiencies."[18] Making clear that his position is a starting point for further dialogue, the Commissioner explained this definition would permit the FTC to prosecute conduct that, while falling outside the Sherman or Clayton Act, would not be controversial, because it is already deemed anticompetitive. Citing modern concepts of antitrust harm, Section 5 would, for example, reach "invitation[s] to collude" or the acquisition of too much market power, falling short of a monopoly.[19] It remains to be seen whether this approach, or one like it, will be formally adopted or pursued. Still, such a definition might sweep within its scope conduct that, in and of itself, does not violate other antitrust laws and lead to potential penalties for legitimate, non-collusive conduct. For example, one might argue that, under such a definition, an oligopoly like the one at issue in *du Pont* could be deemed a violation of Section 5.

Proponents of expansive Section 5 powers note that the FTC is an expert agency that Congress intended to have a central role in policing business conduct. They further note that, unlike the Sherman Act, there is no private right of action under Section 5—which, in theory, limits exposure to damages for conduct that does not, standing alone, violate other antitrust laws. However, while there may be no express private right of action at the federal level, numerous states have enacted their own versions of Section 5 that permit private actions and, in some cases, trebled or punitive damages.[20]

In addition, the FTC has previously sought and obtained significant monetary penalties in the form of disgorgement and restitution. For example, in *FTC v. Mylan Laboratories, Inc.*,[21] the court accepted the FTC's argument that it could seek monetary relief for violations of Section 5, because doing so is a "natural extension of the remedial powers authorized under § 13(b)."[22] The case was later resolved when the defendants agreed to pay $100 million into a fund, that included compensation for indirect purchasers who allegedly were injured.[23] At the time, certain Commissioners recognized the significant federal antitrust policy implications of the settlement, in light of the decisions in *Hanover Shoe, Inc. v. United Shoe Machinery Corp.* and *Illinois Brick Co. v. Illinois*.[24]

More recently, in July 2012, the FTC withdrew its existing Policy Statement on Monetary Remedies in Competition Cases that had been in place since 2003. The Statement outlined those circumstances where the FTC would seek monetary penalties. In withdrawing it, the FTC explained that "the practical effect of the Policy Statement was to create an overly restrictive view of the Commission's options for equitable remedies."[25] This may signal the likelihood that US businesses will see more FTC attempts to impose monetary penalties in future competition cases.

Further, private plaintiffs regularly cite enforcement proceedings to demonstrate the plausibility of their claims and evade dismissal motions. An expert agency's determination that certain conduct constitutes an "unfair method of competition," even if not falling within the strict contours of a traditional Sherman Act claim, could be an element relied upon by private plaintiffs to successfully plead a Sherman Act claim, opening the door to the expense of antitrust discovery and the potential for trebled damages. For example, a private plaintiff might rely upon Section 5 proceedings based on so-called "invitations to collude," or the exchange of commercially sensitive information, to demonstrate a plausible Sherman Act Section 1 claim.[26] Indeed, a jury might be permitted to infer the existence of a tacit agreement based on this type of conduct.[27]

Consider a case like *In re Bosley*,[28] where the FTC found that an exchange of competitively sensitive information could "mutate into a conspiracy" and "[c]ompetition may be unreasonably restrained whenever a competitor directly communicates, solicits, or facilitates exchange of competitively sensitive information with its rivals." Such proscriptions conceivably sweep in a wide variety of completely legitimate conduct. And, although it is clear that such conduct, standing alone, is not enough to plead a traditional antitrust violation—since plaintiffs must allege more than just an "opportunity" to collude[29]—the existence of FTC proceedings and/or an adverse FTC finding may nonetheless help plaintiffs get beyond the pleading stage of a Sherman Act claim.[30] What is more, the modern enforcement environment makes it unlikely that firms will elect to litigate a Section 5 claim—all but foreclosing the possibility that a robust body of case law may someday develop. As in all types of adversarial proceedings, firms elect to settle Section 5 claims for a variety of reasons, including a desire to avoid protracted costs, inherent uncertainty, bad publicity and potential sanctions that can come from choosing to litigate with the government.

So, what can firms do to avoid running afoul of Section 5? Because the FTC has yet to adopt any specific parameters that define the boundaries of Section 5 power, companies continue to be left in the dark as to precisely what type of conduct amounts to a violation. This uncertainty makes it more important than ever to provide employees with careful guidance on how to limit exposure and avoid sliding into "gray" areas. Also, further guidance from the FTC could be coming soon.

After decades of relative silence on the issue, this past year saw a growing coalition of support for establishing Section 5 guidelines. For instance, in addition to the (albeit vague) limiting principles proposed by Commissioner Wright, several members of Congress also recently encouraged the FTC to specify the scope of its Section 5 authority. Corporate counsel should keep abreast of these developments, because, until the FTC formally clarifies its position on the reach of Section 5, US businesses will be forced to wrestle with how to ensure compliance with an ambiguous law. ◆

Endnotes

1 See Federal Trade Commission, About the Bureau of Competition, available at http://www.ftc.gov/bc/about.shtm.

2 See id. at http://www.ftc.gov/bc/non-merger.shtm.

3 15 U.S.C. § 45(a)(6).

4 See Section 5 Recast: Defining the FTC's Unfair Methods of Competition Authority, Remarks of Joshua D. Wright, FTC Commissioner, available at http://www.ftc.gov/speeches/wright/130619section5recast.pdf; Concurring Opinion of Commissioner Jon Liebowitz at 3, *In re Rambus, Inc.*, FTC Docket No. 9302 (Aug. 2, 2006), available at http://www.ftc.gov/os/adjpro/d9302/060802rambusconcurringopinionofcommissionerleibowitz.pdf.

5 See H.R. Rep. No. 63-1142, at 19 (1914).

6 *Federal Trade Commission v. R.F. Keppel & Bro.*, 291 U.S. 304, 310 (1934).

7 See Concurring Opinion of Commissioner Jon Liebowitz at 1-2, *In re Rambus, Inc.*, FTC Docket No. 9302 (Aug. 2, 2006), available at http://www.ftc.gov/os/adjpro/d9302/060802rambusconcurringopinionofcommissionerleibowitz.pdf.

8 See *Federal Trade Commission v. R.F. Keppel & Bro.*, 291 U.S. 304, 311-12 (1934)

9 Although the Supreme Court has not recently revisited this issue, in *F.T.C. v. Indiana Federation of Dentists*, 476 U.S. 447, 454-55 (1986), the Court signaled its continued adherence to Sperry. In that case, which is now also more than 25 years old, the Court explained: "[t]he standard of 'unfairness' under the FTC Act is, by necessity, an elusive one, encompassing not only practices that violate the Sherman Act and the other antitrust laws, but also practices that the Commission determines are against public policy for other reasons."

10 *FTC v. Sperry Hutchinson Co.*, 405 U.S. 233, 234 (1972). Trading stamps are similar to postage stamps.

11 Id. at 235.

12 Id. at 239.

13 Id. at 244.

14 729 F.2d 128, 130, 137 (2d Cir. 1984).

15 Id. at 138-39

16 Id. at 138-39.

17 See James Campbell Cooper, Working Paper No. 13-20, *The Perils of Excessive Discretion, The Elusive Meaning of Unfairness in Section 5 of the FTC Act* (November 2013), available at http://mercatus.org/publication/perils-excessive-discretion-elusive-meaning-unfairness-section-5-ftc-act.

18 Section 5 Recast at 15.

19 Section 5 Recast at 19-20.

20 Hakala, Justin J., *Follow-On State Actions Based on the FTC's Enforcement of Section 5, 7-9* (Wayne State Univ. Law Sch., Working Paper Grp., Oct. 9, 2008), available at http://www.ftc.gov/os/comments/section5workshop/537633-00002.pdf.

21 62 F.Supp.2d 25, 37 (D.D.C. 1999).

22 15 U.S.C. § 53(b).

23 See FTC Press Release, available at http://www.ftc.gov/es/node/64092.

24 See id. ("[a] particularly serious spillover effect of the federal court decisions in this case is the potential conflict with federal policy established by the decisions in *Hanover Shoe, Inc. v. United Shoe Machinery Corp.* and *Illinois Brick Co. v. Illinois*, and consistently maintained since that time.")

25 See FTC Press Release, available at http://www.ftc.gov/news-events/press-releases/2012/07/ftc-withdraws-agencys-policy-statement-monetary-remedies.

26 See, e.g., Thomas Dahdouh, Section 5, *The FTC and Its Critics: Just Who Are the Radicals Here?*, 20 No. 2, J. Antitrust & Unfair Comp. Law of Cal. 1, 20-21 (Fall 2011).

27 *Monsanto Co. v. Spray–Rite Service Corp.*, 465 U.S. 752, 764 n. 12 (1984)

28 See ANALYSIS OF AGREEMENT CONTAINING CONSENT ORDER TO AID PUBLIC COMMENT, *In re Bosley, Inc.*, File No. 121-0184 at 2 (2013) available at http://www.ftc.gov/sites/default/files/documents/cases/2013/04/130408bosleyanal.pdf.

29 See, e.g., *Bell Atlantic Corp. v. Twombly*, 550 U.S.544, 567 (2007); *In re Citric Acid Litig.*, 191 F.3d 1090, 1098 (9th Cir. 1999); *Cosmetic Gallery, Inc. v. Schoeneman Corp.*, 495 F.3d 46, 53 (3d Cir. 2007); *Williamson Oil Co. v. Philip Morris USA*, 346 F.3d 1287, 1319 (11th Cir. 2003).

30 Indeed, some courts have allowed Sherman Act claims to proceed past the pleading stage even though the alleged practice was "not illegal in itself," because the conduct purportedly "facilitate[d] price fixing." *In re Text Messaging Antitrust Litigation*, 630 F.3d 622, 627–29 (7th Cir. 2010).

Brazilian Competition Policy in Global Context: Achievements and Challenges

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Observations in this article about Brazilian law are by Tauil & Chequer Advogados. They are not intended to provide legal advice to any entity; any entity considering the possibility of a transaction must seek advice tailored to its particular circumstances.

Enforcement of antitrust law in Brazil has continued its trend toward consolidation and evolution.[1] Brazil's economic growth has resulted in more complex transactions being submitted to merger control, as well as more complex and veiled antitrust investigations. In turn, this has increased the visibility and relevance of the Brazilian System for Economic Defence (SBDC) and, especially, of the Administrative Council for Economic Defence (CADE), the country's main antitrust agency.[2]

According to CADE's 2012 Annual Report, CADE has increased the number of its technical staff, and given them more responsibility, resulting in a rise in the number of cases analyzed per year: from 666 in 2005 to 955 in 2012, out of which 825 were merger filings notified under the old regime and 102 merger filings submitted under the new regime. In the first half of 2013, 82 new proceedings were filed, 158 were ruled on (out of which 59 were merger filings) and only 219 remain under analysis.

In addition to the staff increase, the reformulation and the enhancement of cooperation within the SBDC (i.e., the Secretariat of Economic Monitoring—SEAE, the Secretariat of Economic Law—SDE, CADE's Attorney General Office, and Federal Public Prosecution Office and CADE) eliminated overlapping activities and significantly reduced the average analysis period of merger filings—from 252 days in 2005 to 48 days (ordinary procedure) and 19 days (summary procedure), both in 2012.

The depth and strength of the decisions can also be regarded as an achievement. For example, since the New Brazilian Antitrust Law (Law No. 12529/2011) came into effect, CADE has been keeping an eye on healthcare markets. This has resulted in significant restrictions being imposed in some transaction involving the acquisition of hospitals in several Brazilian cities, including Rede D'Or and Medgrupo Participações S.A., the veto of the acquisition of Hospital Regional de Franca by Unimed and the acquisition of Aliança by Qualicorp in the healthcare insurance sector.

Additionally, in May 2012, CADE authorized the assets swap between Brasil Foods (BRF) and Marfrig Alimentos S.A., in compliance with heavy commitments of selling assets assumed by BRF involving approximately 35 percent of the parties' production capacity in Brazil comprising production facilities, distribution centers and an important portfolio of products and brands.[3] Also, the authority cleared the transaction between the airline companies LAN and TAM, subject to the swap with a competitor of some slots and infrastructure in the São Paulo International Airport and to the exit of one of the worldwide airline company's alliances (One World or StarAlliance).[4]

In the steel sector, CADE granted an injunction to prevent completion of the acquisition by the Brazilian Companhia Siderúrgica Nacional (CSN) of additional stakes in its competitor, Usinas Siderúgicas de Minas Gerais S.A. (Usiminas).[5] CADE ordered that until a final decision is rendered and subject to the imposition of fines of Brazilian Real (BRL) 10 million plus BRL 10,000 per day of violation, CSN would not be allowed to appoint any member to the board of directors or any other management board of Usiminas. Cade also ordered that no company of CSN's economic group should have access to competitively sensitive information or exercise any management or political rights over Usiminas (e.g., voting in the general shareholders' meetings). In addition to this, CADE imposed restriction in the creation of a partnership between Usiminas and nineteen distributors of flat steel, eliminating an exclusivity clause set forth in their agreement.

While still under the old regime, CADE executed some Agreements to Preserve Reversibility of the Transaction (APROs) in important transactions in order to maintain the competitive environment, as well as to keep the parties independent until a final decision was reached. This was the case in the merger between the Brazilian airline companies Gol and WebJet,[6] as well as the transaction concerning the acquisition by Diagnósticos da América S.A. (DASA) of control over MD1 Diagnósticos S.A.,[7] and the subsequent acquisition by AMIL Group of participation on DASA's shares in the health assistance and diagnosis services sector.

Under the new regime, CADE has entered into the first merger control settlement agreements (ACCs) in transactions that raised competition concerns, as a condition for their clearance under the Law No. 12529/11. The first such case refers to the acquisition of Mach by Syniverse. During examination, the General Superintendence found that the transaction would result in high concentration in the GSM data clearing and Near Real Time Roaming Data Exchange (NRTRDE) markets, which are technological services provided to mobile telecommunication companies for the charging of roaming. To remedy competition concerns, Mach and Syniverse proposed executing the agreement, through which they undertake certain obligations to remove any anticompetitive outcomes from the transaction.

In the second case, involving Ahlstrom Corporation and Munksjö AB, CADE concluded that there was high concentration in the pre-impregnated decorative paper (PRIP) market and in the heavy abrasive paper market, and that there were neither prospects of new entrants into the sectors nor sufficient firms able to compete in these markets. Therefore, the sale of an industrial unit of Ahlstrom was established as a condition to the deal.

CADE also cleared complex transactions, e.g., the merger between two big retailers Casas Bahia and Ponto Frio, acquisition of Skype by Microsoft, several acquisitions in the meat sector by JBS (although CADE is monitoring the market by means of monthly reports sent by the company).

Interestingly, CADE cleared the transaction between airline companies Azul and Trip, on the condition that by the end of 2014, the flight share agreement (code share) that Trip has with TAM be terminated as well as the use with intensity at least of 85 percent of their scheduled takeoffs and landings at the Santos Dumont airport, located in Rio de Janeiro. However, this case demonstrated that CADE is carefully reviewing and verifying all the information provided by the applicants, as the authority imposed an R$3.5 million fine (out of a maximum of R$5 million) on the companies for presenting misleading information. This kind of penalty had already been provided by former Law No. 8884/94, although there are no decisions that are worth mentioning in this sense. The penalty was maintained in Law 12529/2011, and only now has CADE applied a strict analysis of accuracy and completeness to information provided by the parties and demonstrated its willingness to punish any minimal evidence of misleading information.

In the case *Azul/Tryp*, for instance, CADE imposed such a high fine because the parties did not provide information about the existence of a code share agreement with TAM. This information came out during complementary discovery by CADE and was determinant to the imposition of restrictions to the transaction.

The second, and more recent case of misleading information involves Lauriate Group and the Brazilian private university Anhembi Morumbi, which were fined in R$4 million for hiding information of their economic groups, which would show that a Lauriate Group's members were already active in the educational sector. The transaction involved the rise of equity interest of Lauriate Group in the managing company of Anhembi Morumbi from 51 percent to 100 percent.

The first precedent of misleading information concerned the transaction between the companies Cruzeiro do Sul Educacional S.A. and ACEF S.A., in the distance learning sector. According to CADE, the parties did not inform an accurate number of courses offered and the number of students enrolled. CADE imposed a fine of R$200,000.

Under the new regime, CADE has also focused the analysis of merger filings on consolidating a restrictive and objective approach in regard to the notification thresholds, as well as acknowledging the need to enact regulations concerning some concepts of Law No. 12529/11, such as the "associative agreements" (including distribution agreements, consultancy agreements, partnerships in general, service agreements, etc.) that fall within the scope of antitrust law, as well as the concepts of control and relevant influence for the purposes of submitting a transaction to merger control.

CADE also evolved controlling behaviors, such as cartels and unilateral conducts; however, society is still waiting for a development in this sense, be it in terms of speedy to conclude the cases, be it in terms of willingness to face more cases.

All of the changes to the SBDC that have taken place are still not enough to put Brazil in the first tier in terms of antitrust enforcement and competition culture. Cultural and latent problems, not exclusively related to competition law and to the SBDC, but rather related to Brazil as a whole, have made the challenge that much greater.

In this regard, it is important to recognize that competition law in Brazil is still less than 20 years old. Competition culture has not yet been fully established at the academic or governmental levels, let alone the business environment or society as a whole.

The tripod underlying the Brazilian Competition Policy (merger control, behavior control and competition advocacy) is still being developed. In merger control, CADE is facing a quite settled case law and methodology, which, in addition to the institutional maturity, gives the society the desired predictability of whether a transaction should be submitted to CADE and whether there will be difficulties for unconditional clearance.

CADE has continued to develop its efforts at behavioral control. This can be observed by the number of cases it has ruled on, the level of penalties applied and the outcomes of the judicial decisions when CADE's rulings have been challenged. However, CADE needs to keep developing and refining its investigations in order to signal to society that it is not worth the risk to violate antitrust laws.

For new cases, the leniency program is still something of an unknown. It brings little confidence because Brazil's legal tradition is not used to granting benefits to criminals who, in admitting to and giving information on their crimes, assist in the conviction of other possible wrongdoers. However, leniency agreements are useful for the authorities because they make it possible to obtain information that would be very hard to obtain in the normal course of an investigation.

Additionally, the unilateral conduct cases are not a small challenge to be faced. CADE has not many cases of conviction, but stared to fix its position, what was seen in the case SKF (2013), the first conviction for resale price maintenance. The case involving Banco do Brasil and exclusive dealing in payroll loans (2012) can be also regarded as an achievement. More cases of unilateral conducts, including those related to state-owned enterprises, might arise and lead CADE reinforce its mandate for free competition and a level playing field regime within the Brazilian markets.

CADE is commencing to define its role on competition advocacy, which might be shared with SEAE. Problems related to taxation could trigger this very important pillar of competition law in Brazil. Both of them shall think antitrust in a broader manner in order to contribute to social welfare as much as possible. The Brazilian society is anxious for a support of the expert on competition to help the country become more competitive and fair. ◆

Endnotes

1 Competition and Antitrust are synonyms in Brazil; thus this article uses either Competition Law or Antitrust Law.

2 The SBCD, the Brazilian antitrust system, is composed of three administrative entities that are jointly responsible for the antitrust enforcement: (i) Secretariat for Economic Law of the Ministry of Justice (SDE); (ii) Secretariat for Economic Monitoring of the Ministry of Finance (SEAE); and (iii) Administrative Council for Economic Defense (CADE).

3 *Brasil Foods S.A./Marfrig Alimentos S.A.* Concentration Act No. 08012.011210/2011-67. Introduced in November 2011, and cleared in July 2012.

4 *TAM S.A./Lan Airlines S.A.* Concentration Act No. 08012.009497/2010-84. Introduced in September 2010, and cleared in December 2011.

5 *Companhia Siderúrgica Nacional/Usinas Siderúgicas de Minas Gerais S.A.* Concentration Act No. 08012009198/2011-21. Introduced in September 2011 and cleared in April 2012.

6 *Webjet Linhas Aéreas S.A./VRG Linhas Aéreas S.A.* Concentration Act No. 08012.008378/2011-95. Introduced in July 2011, and cleared in October 2011.

7 *MD1 Diagnósticos S.A./Diagnósticos da América S.A.* Concentration Act No. 08012.010038/2010-43. Introduced in September 2010, and cleared in October 2011.

Mobile Payments Systems: Potential Competition Concerns

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The mobile payments systems ("m-payments") ecosystem encompasses hardware manufacturers, operating system developers, application developers, data brokers, coupon and loyalty program administrators, payment card networks, telecommunications providers, advertising companies, brands and end merchants. Smart phones and payment cards, by themselves, have invited scrutiny from competition regulators, and it is likely that the convergence of the multitude of players, technologies and participants for the development of m-payments will be closely monitored by competition regulators.[1]

The European Commission ("Commission") has already examined three transactions relating to m-payments.[2] It is also understood that the Commission has in December 2013 constituted a group bringing together officials from several departments covering antitrust law, technology, consumer rights, industry and the internal market to examine new payment technologies. Sets of competitors have formed mobile payment joint ventures in the United States as well.[3]

The nature of mobile commerce is changing at a rapid pace, and the competition regulators will focus on issues that impede the development of the market through exclusionary conduct, either collective or unilateral, and erection of artificial barriers to entry. The next section will discuss issues related to a completion analysis that different actors in the m-payments ecosystem need to be aware of when launching products or entering into collaborative arrangements.

Potential Competitive Concerns in M-Payments Ecosystem

1. *Standard-setting and restrictive effects*

The Commission has recently published a Green Paper[4] in which it has expressed its concerns that companies controlling the standards, and, hence, interoperability, would dominate the whole payment chain: the device itself, the application platform and security management.[5] The Green Paper further states that standardization work on m-payments should ensure full interoperability between m-payment solutions and favor open standards to enable consumer mobility.[6]

While technical standards have already been developed[7] for Near Field Communications ("NFC")[8], further developments are still expected.[9] For example, no standards exist to enable customers to pay, redeem coupons and claim loyalty points at the same time with their mobile handsets.[10] In this relation, development of closed standards and specifications that the whole industry would be forced to use and that the standard-developing company/companies would have the freedom to license or not and establish conditions relating to their use would attract scrutiny from competition regulators.

Participants to the standard-setting process would need to ensure that participation in standard-setting is unrestricted, that the procedure for adopting the standard in question is transparent and that the standardizations agreements contain no obligation to comply with the standard. Further access to the standard is to be provided on fair, reasonable and non-discriminatory terms.[11]

2. *Creation of market power and diminishing innovation*

Joint ventures, strategic alliances and other collaborations among competitors are already an important component in the m-payments ecosystem. In markets where innovation is an important competitive force, this may increase the firms' ability and incentive to bring new innovation to the market and thereby, the competitive pressure on rivals to innovate in the market. However, increased market power as a result of such commercial arrangements may include the ability to diminish innovation.[12] Network effects[13] heighten the importance of technology in the m-payments ecosystem.

In order to process payments securely, the presence of a secure element ("SE")[14] is necessary. Usually, mobile network operators ("MNOs") would have the content management rights[15] and control the access to the SE if it is placed inside the SIM ("Subscriber Identification Module") card. There is an apprehension that if the only viable technologies are SEs that are controlled by MNOs, then control of the SEs may create market power for MNOs. This would reduce competition or diminish innovation in m-payment technologies.[16] For example, the Commission has examined whether the MNOs that had entered into a joint venture arrangement for providing mobile wallet services[17] had the technical or commercial ability to block/degrade/subordinate/deactivate their competitors' mobile wallets using an SE, such as embedded SE.

Diminishing innovation is not as problematic if alternative security solutions exist that do no require access to be granted by the MNO. In such a situation, the owner/controller of the SE would be unable to exercise market power.

3. *Impact on fees*

Financial institutions currently are the main players in the payments industry. Competition regulators have had long-standing competition concerns, particularly in relation to the levy of interchange fees. The competition regulators would examine the establishment of structures that could perpetuate the current model for generation of fees.

M-payments systems open the market to other sectors, such as telecom and operating system manufacturers, all of which would want a share of the revenues. The Commission's Green Paper considers that MNOs seem to be seeking to retain control of the m-payments business, at least in their role of security manager for the service.[18] A concern that has been raised is that if the only viable technologies are SE solutions that are controlled by MNOs, then MNOs may seek to exercise market power by collecting substantial transaction fees on all m-payments.[19] The development of the revenue sharing model is therefore likely to be closely scrutinized by the competition regulators.

4. Exclusivity and tying arrangements

The combination of products in related markets may confer the ability and incentive to leverage a strong market position from one market to another via tying, or other exclusionary practices. Technical tying occurs when the tying product is designed in such a way that it only works with the tied product and not with the alternatives offered by competitors. Contractual tying entails that when purchasing the tying good, the customer undertakes only to purchase the tied product and not the alternatives offered by competitors.[20]

In relation to m-payments systems, there is a complementary relationship between the issue of payment cards and the provision of digital wallet services that could give rise to conglomerate effects.[21] Such conglomerate effects may be facilitated through exclusionary practices, such as tying. In relation to the creation of a joint venture for providing digital wallet services by issuers of payment cards, an important part of the analysis would be whether (i) the joint venture would have the ability to restrict the use of payment cards in its digital wallet to cards of the parent companies, (ii) there are sufficient alternative issuers of payments cards, (iii) there are competing digital wallets supporting the use of competing financial institutions other than the parents of the joint venture and (iv) the parents would restrict the ability of use of payment cards issued by them in competing digital wallets.[22] Harm may be considered to arise if a joint venture denies some key element to a rival.

When entering into exclusivity arrangements, companies should consider factors such as the freedom that the joint venture's members have to participate in multiple m-payment systems, the extent to which the members—individually or collectively—have market power with respect to the denied element and the availability of adequate substitutes for that element. ◆

Endnotes

1 OECD Roundtable on Competition and Payment systems, See para 4.2 of note by United States, dated 19 October 2012.

2 Case No COMP/M.6314 – Telefónica UK/Vodafone UK/ Everything Everywhere/JV dated 4 September 2012, Case No COMP/M.6956 - Telefonica/Caixabank/Banco Santander/JV dated 14 August 2013 and Case No COMP/M. 6967- BNP Paribas Fortis/Belgacom/Belgian mobile wallet dated 11 October 2013.

3 Isis, a joint venture including most of the major American mobile phone network providers, and Merchant Customer Exchange, a joint venture of many merchants Members of MCX include Wal-Mart, Target, CVS, Sears, Lowe's and Shell Oil.

4 Green Paper, "Towards an integrated European market for card, internet and mobile payments," dated 11 January 2012.

5 Green Paper, "Towards an integrated European market for card, internet and mobile payments," dated 11 January 2012, para 4.4.1., p.17.

6 Ibid., p.16.

7 See Commission decision of 4 September 2012 in Case No COMP/M.6314 – Telefónica UK/Vodafone UK/ Everything Everywhere/JV, paragraphs 370, 373 and 376.

8 NFC is a type of wireless communications technology that can be used to effect a payment where two devices, such as a smart phone and reader, communicate through short-range radio waves.

9 *Financial Times* report dated 1 October 2013 by Jeevan Vasagar, "Visa, MasterCard and American Express are proposing a new industry standard to make online payments more secure, by eliminating the need to enter account numbers when shopping online or on mobile devices."

10 See Commission decision of 4 September 2012 in Case COMP/M.6314 Case No COMP/M.6314 – Telefónica UK/ Vodafone UK/Everything Everywhere/JV, paragraph 379.

11 *Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal cooperation agreements*. See Commission decision of 4 September 2012 in Case COMP/M.6314 Case No COMP/M.6314 – Telefónica UK/Vodafone UK/Everything Everywhere/ JV, paragraph 253.

12 *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings*, OJ C 31, 5 February 2004, paragraphs 8 and 38.

13 Network effects occur where users' valuations of the network increase as more users join the network. For example, as new customers enter a telephone network, this might add value to existing customers because they would be connected to more people on the same network. If customers benefit from being on the same network (e.g., due to incompatibility with other networks), an incumbent with a well-established network might have an advantage over a potential entrant that is denied access to the established network and so has to establish its own rival network. *Guideline of the Office of Fair Trading: Assessment of market power*, paragraph 5.21.

14 An SE could be located on the (i) Subscriber Identification Module ("SIM") card; (b) on a (micro) Secure Digital ("SD") card that can be integrated in some mobile handsets, including, at the same time, the NFC technology; (c) on an external device, such a Universal Serial Bus ("USB") key; (d) in the chip that is embedded in the mobile handset's hardware ("embedded SE"); and (e) in the cloud.

15 Content management rights allow the holder, for example, to load the initial keys governing access, the application code and confidential data for personalization or to update data or code.

16 OECD Roundtable on Competition and Payment systems, See paragraph 5 of note by United States, dated 19 October 2012.

17 There are two approaches to what is commonly described as a mobile wallet. First, a container wallet, which, at a minimum, provides the consumer with an overview of all applications that are loaded into the SE and allows a consumer to select which payment cards are switched on and off and to set priorities between them. This mobile wallet serves as a container for all the consumer's virtual payment cards and allows the configuration of the SE even from different card issuers, in a similar fashion to a consumer having several payment cards physically in his or her wallet. Second, an app-centric wallet, which contains only one application that can include several cards, but from the same issuer. Each individual card stored on the SE is represented by a corresponding application on the mobile handset. A card belonging to an individual service provider therefore shows up as an individual application on the mobile handset. In the physical world, it would be equivalent to a plastic card. See Commission decision of 4 September 2012 in Case COMP/M.6314 Case No COMP/M.6314 – Telefónica UK/Vodafone UK/Everything Everywhere/ JV, footnote 3.

18 Green Paper, "Towards an integrated European market for card, internet and mobile payments." dated 11 January 2012, paragraph 4.4.1., pg.17.

19 OECD Roundtable on Competition and Payment systems, See paragraph 5 of note by United States, dated 19 October 2012.

20 *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings*, OJ C 31, 5 February 2004, paragraph 97.

21 Case No COMP/M.6956 - Telefonica/ Caixabank/Banco Santander/JV dated 14 August 2013, para 73.

22 Case No COMP/M.6956 - Telefonica/ Caixabank/Banco Santander/JV, paragraphs 75 to 88.

Loyalty Discounts Becoming More Complicated Than Ever

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According to a sharply divided opinion from the US Court of Appeals for the Third Circuit, discounts conditioned on customer loyalty can be anticompetitive even if the discounted price still exceeds the seller's cost. Further, a seller's insistence that dealers charge less for its brand than for rival brands can also spell trouble.

In its 2012 decision in *ZF Meritor, LLC v. Eaton Corp.*,[1] the Third Circuit confirmed that "loyalty discounts"—in which a seller provides price reductions or rebates to customers that buy at least a specified percentage of their purchases of a product from that seller—can violate the antitrust laws even if the discounted price is not below the seller's cost, and even if eligibility for the discount does not require 100 percent loyalty. How to tell whether a loyalty discount crosses the line depends on a variety of factors under the Third Circuit's approach, and the opinion illustrates some things that sellers may want to avoid. Also folded into the opinion is an important reminder of the risk associated with agreements with dealers that restrict the prices those dealers may charge for ***competing*** brands.

Discounts. The case involved loyalty discounts offered by Eaton Corporation, the leading maker of heavy-duty truck transmissions with a market share in excess of 80 percent. There were only four customers in the industry—the four manufacturers of heavy-duty trucks—and Eaton offered all of them contracts providing rebates conditioned on their purchasing 70 to 97.5 percent of their requirements from Eaton for a term of at least five years. The contracts provided that if a manufacturer did not meet its target, Eaton could require repayment of the rebates and also could pull the plug on the entire contract. Eaton's only competitor was ZF Meritor, which introduced an innovative new transmission in 2001, but did not offer as full a line as Eaton. ZF Meritor disappeared from the business in 2007, but not before initiating this lawsuit.

Preferred Pricing. In addition to incorporating loyalty discounts, Eaton's contracts required the truck manufacturers to charge truck buyers a "preferential price" for Eaton transmissions so that Eaton transmissions were always priced lower than those of its competitors. One truck manufacturer was instructed to price ZF Meritor transmissions at a $200 premium over

Eaton transmissions, while other manufacturers agreed to impose what they termed a penalty on ZF Meritor transmissions. In addition, at Eaton's urging, the truck manufacturers imposed additional price penalties on customers that selected ZF Meritor products.

Holding. In a 2-1 decision, the Third Circuit affirmed the district court's order against Eaton, upholding a jury verdict. The court rejected Eaton's argument that a loyalty discount cannot violate the antitrust laws unless it results in sales at below cost. The court held that although, without more, loyalty discounts involving a single product (not a bundle of products) are not anticompetitive unless the resulting price is below cost, other factors in this case resulted in "*de facto* partial exclusive dealing."

Principally, because of Eaton's large market share and entrenched customer demand, Eaton's products amounted to "necessary products" and so "losing Eaton as a supplier was not an option." Truck manufacturers therefore were not really "free to walk away" from their long-term contracts if a competitor offered a better price, even though the terms of the contracts provided that they could. No truck manufacturer "could satisfy customer demand without at least some Eaton products, and therefore no [manufacturer] could afford to lose Eaton as a supplier." Perhaps a better question would have been whether any truck manufacturer could afford to lose the Eaton discount. In any event, the court observed that "exclusive dealing arrangements can exclude equally efficient (or potentially equally efficient) rivals, and thereby harm competition, irrespective of below-cost pricing."

Implicit in this approach, but never articulated, is the fact that if some portion of the transmissions that each manufacturer bought from Eaton really amounted to "necessary" or "must have" products—because truck buyers would accept no substitute—then the "discount attribution rule" developed by other courts would require the entire discount provided to that manufacturer to be attributed only to the portion for which ZF Meritor realistically could still compete. If, with this recalculated discount, Eaton's sales were still above cost for that portion, there could be no liability because an equally efficient competitor could meet the adjusted price for that portion alone. The court never required or undertook this analysis, relying instead on its more amorphous theory of what constitutes *de facto* exclusivity coupled with the large share of the market thereby foreclosed.

The court also was not persuaded by the fact that Eaton's discounts did not require complete exclusivity and allowed truck manufacturers to purchase some transmissions from competitors without losing the discount on Eaton products. Although the court cited with approval cases that upheld programs requiring customers to purchase 60-80 percent of their needs in order to qualify for a discount, it noted that three of the truck manufacturers here were required to purchase 90 percent from Eaton, and the fourth was required to purchase 70 percent only because it made some of its transmissions itself. The court held that this resulted in the same foreclosure that would result from "complete exclusive dealing arrangements with 90 percent of the customer base" and therefore did not preclude a *de facto* exclusive dealing claim.

As for the preferential pricing requirement, the court held that it was reasonable for the jury to find this anticompetitive. The evidence showed that while some of the discounts on Eaton products were passed along by truck manufacturers to truck buyers, there also was evidence that the truck manufacturers achieved preferential prices for Eaton transmissions by "artificially increasing" the prices for ZF Meritor transmissions. This is not the first decision to challenge limitations on the gap a dealer must maintain between the prices of competing products. Although it may seem pro-competitive for a supplier to require that "My brand must be sold for less than other brands," if the customer sets the resale prices for all brands, this is no different from requiring that "Other brands must be sold for more than my brand." Depending on the dealer's cost for each brand, such a restriction might result in higher prices for all brands.

Judge Greenberg filed a long and impassioned dissent. To Judge Greenberg, the foundation of Eaton's program was the availability of a discount that did not result in sales below cost and this should have been the end of the analysis. He concluded by writing: "I do not know how corporate counsel presented with a firm's business plan…if it is a dominant supplier that seeks to expand sales through a discount program…will be able to advise the management," other than "to take a chance in the courtroom casino" some time in the future.

This case is important because it holds, over strong resistance, that discounts inducing exclusive dealing and quasi-exclusive dealing can result in unlawful foreclosure of competitors even if there is no bundling of different types of products and even if there is no selling below cost. This may not be the last chapter in this saga, however, because eventually this issue is likely to attract the attention of the Supreme Court, which has not taken a close look at exclusive dealing in almost 30 years. ◆

Endnote

1 *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254 (3d Cir. 2012).

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