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SHARES

PRIVATE EQUITY + CRESSE

CPI COMPETITION POLICY INTERNATIONAL

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LETTERS FROM THE EDITORS

I. PRIVATE EQUITY

Dear Readers,

What does competition law have to do with private equity investments? If you listen only to the investors, the answer is "not very much." But in fact the authorities have a substantial interest in determining whether a private equity transaction, like any other acquisition of stock or assets, has an adverse impact on competition. Are these private equity transactions in fact reportable, or do they slide by the filing and waiting requirements? Does it matter if the private equity investor is seeking board membership, or to change management direction of the target? In this issue, our authors look at these issues as they arise in the United States, the EU, Brazil and other jurisdictions. The companies investing may be private. But the impact of their actions implicates some basic and established public antitrust policies.

Kent Bernard
Fordham University School of Law

II. SELECTED ARTICLES FROM CRESSE 2017

This section of the January 2018 CPI Antitrust Chronicle includes articles based on presentations from Special Policy Sessions ("SPS") of the 12th Annual CRESSE Conference organized from 30th June – 2nd July 2017.

CRESSE (www.cresse.info), is an international network of academics and other professionals, with an interest in Competition Policy and Sectoral Regulation. Every year CRESSE organizes an international conference in Greece that is widely recognized as one of the top academic conferences in the economics of competition policy and regulation worldwide. For the 2018 Conference to be organized from 29th June – 1 July, Keynote Speakers will include John Vickers, Dennis Carlton, David Evans, Herbert Hovenkamp and Eleanor Fox.

An important feature of the annual CRESSE Conference is the organization of a number of SPS in which important topical issues of competition policy are discussed between academics (economists and lawyers), policy makers, corporate representatives and practitioners. One of the SPSs organized during the 2017 Conference, coordinated and chaired by Patrick Rey was on the subject of "Vertical Restraints in Digital Markets." Contributions dealt with a number of potentially anticompetitive practices in the form of vertical restraints in digital/ecommerce markets. The contribution of John Asker and Heski Bar-Issac included in this edition of the Chronicle deals with restraints related to advertising and, specifically, restraints in the form of a minimum advertising price restriction placed by manufacturers on retailers. In another contribution, Thibaud Vergé reviews the literature and recent cases examining effects of price parity clauses, also referred to as retail most-favored nation clauses that have recently triggered several antitrust investigations, almost all of them in cases in markets involving intermediation platforms.

Finally, the contribution by Fiona Scott Morton deals with another issue on which a CRESSE session focused: the potential competition concerns raised by institutional horizontal shareholding. Specifically, her article addresses the problem that a large institutional fund has both the incentive to soften competition among portfolio firms, and through corporate governance communications, information flow, and creation of incentives, it also has the ability to soften the intensity of competition among portfolio firms.

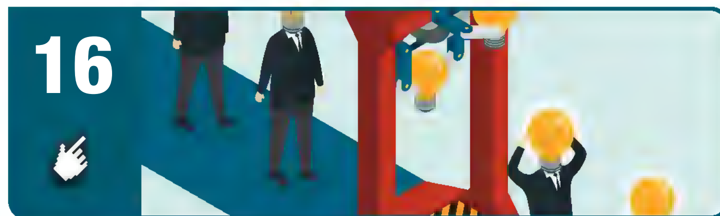
Yannis Katsoulacos
CRESSE & Athens University of Economics and Business

SUMMARIES I. PRIVATE EQUITY

Private Equity Meets Antitrust…Complications Ensue

By Kent Bernard

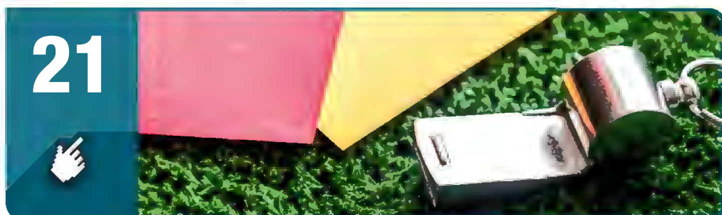
Private Equity is simply a way in which an investment company is structured. What the term usually means, however, is an entity that seeks to make an investment, quickly make changes in the company, and then sell out. Antitrust gets involved to determine whether the acquisition of stock or assets leads to a lessening of competition in any market. As part of that process, potential acquirers must give notice to the antitrust agencies and observe a waiting period. The private equity business model seeks to minimize, or avoid, such waiting. The approaches taken by private equity investors, and the agencies' responses, have created an interesting legal landscape.



Private Equity and Merger Control – The Rules of the Game are Changing

By Pontus Lindfelt & Matteo Giangaspero

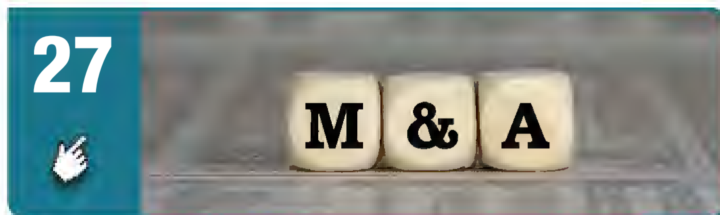
The merger control assessment for transactions involving private equity firms has become increasingly complex. Where time is of the essence, private equity firms need to be pro-active in conducting their merger control analysis prior to initiating a transaction. This analysis requires an in-depth understanding of the structure of the investment funds involved and of the portfolio companies' activities. Additional burdens and risks for private equity firms may originate from the recent EU procedural developments.



Focusing On Private Equity: Global Merger Control Implications

By Deidre Johnson, Simone Waterbury, Adam Eckart, Kevin Walsh & Derek Yee

In a time when cross-border mergers and acquisitions volume has soared to a 10-year high and there are more than 160 jurisdictions worldwide where merger control filings may be required, private equity funds and their advisors must carefully evaluate merger control obligations in each deal. This article discusses key global competition updates and specific considerations for private equity firms, including the divergent views of competition authorities on key definitions, concepts and calculations.



HSR and Antitrust Considerations for Private Equity Firms in M&A Transactions

By Malika Levarlet, Leo Caseria & Ariel Yehezkel

An increasing number of M&A transactions each year involve private equity firms. The parties in private equity deals must be cognizant of the filing requirements under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act") and the substantive requirements of the Clayton Act § 7. Over the years, the HSR rules have been modified to target certain information specific to private equity firms and generally have been adding to the burden of the filing parties in private equity transactions. The requirements sometimes differ from those applicable to deals that do not involve private equity firms. This article discusses some of the HSR and antitrust issues that should be considered, and frequently arise, in private equity transactions.

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Private Equity Buyouts: Anti- or Pro-Competitive?

By Pehr-Johan Norbäck, Lars Persson & Joacim Tåg

Private equity firms ("PE firms") have become common as owners of established firms in concentrated markets. We discuss the antitrust implications of an active PE market and whether there are any special characteristics of PE ownership that are important for antitrust regulation and enforcement. The literature on the impact of private equity ownership on antitrust policy is still in its infancy, but existing studies support some initial insights of relevance to policy.

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Premerger Control of Private Equity Funds: The Brazilian Perspective

By Júlia Batistella-Machado & Bruno Renzetti

This paper provides the reader with an objective view of the premerger control in Brazil of transactions involving private equity funds. The paper suggests that CADE has been historically more concerned with establishing tests and procedures on when and how to submit premerger fillings, than to perform deeper analysis on competitive consequences of said transactions. This may explain the low level of rejections and restrictions imposed by the authority in this context so far. Premerger fillings are mostly done with simplified amounts of data and documents and the duration of the proceeding has been reduced lately, which in most cases is not greater than 30 days.

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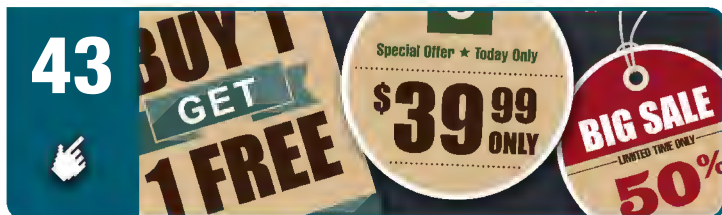

Advertising and Related Restraints

By John Asker & Heski Bar-Isaac

The ecommerce sector is observing substantial use of vertical restraints on advertising and other restraints that seem likely to interfere with the ease with which consumers can find prices. Authorities and commentators have begun to consider such practices and have treated them as equivalent to resale price maintenance. We present an example where this equivalence holds; however, we argue that the conditions required are unrealistic and the underlying economics quite different. In general, MAP and similar restraints allow manufacturers to accommodate diversity (in consumer preferences or retailer costs) and may be pro- or anti-competitive.

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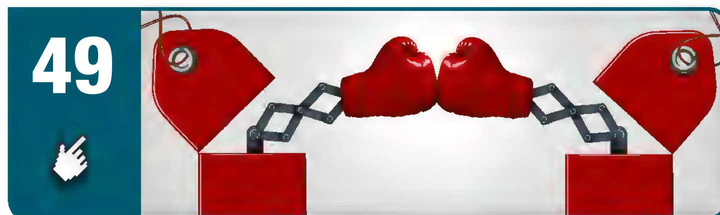

Are Price Parity Clauses Necessarily Anticompetitive?

By Thibaud Vergé

Price parity clauses have recently triggered several antitrust investigations. Although decisions in similar markets have sometimes been conflicting, the agencies tend to rely on the same theory of harm. In this paper, I revisit the recent economic (theoretical and empirical) literature which allows me to identify some of the crucial factors that may lead to anticompetitive effects of such clauses: price parity clauses are more likely to be harmful when suppliers cannot credibly threaten platforms to stop using them in case commissions are seen as excessive. This will occur for instance when the diversion from intermediation platforms to the suppliers' direct sales channel (e.g. own website) is weak.

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Horizontal Shareholding: A Summary of the Argument

By Fiona M. Scott Morton

"Horizontal shareholding" occurs when one or more equity funds own shares of competitors operating in a concentrated product market. A growing body of empirical literature concludes that under these conditions market output in the product market is lower and prices higher than they would otherwise be. Successful private litigation under the Clayton Act would cause significant disruption to equity markets because of its inherent unpredictability, and might not eliminate most of the harms from common ownership. To minimize this disruption while achieving competitive conditions in oligopolistic markets, the DOJ and the FTC should take the lead by adopting a policy that balances harms from lack of competition with efficient functioning of institutional investors.

WHAT'S NEXT?

The February 2018 Antitrust Chronicle will be part two of our series focusing on the **Digital Economy – Mergers.**

ANNOUNCEMENTS

HAPPY NEW YEAR 2018!

CPI wants to hear from our subscribers. To get things started in 2018, we will be reaching out to members of our community for your feedback and ideas. Let us know what you want (or don't want) to see, at: antitrustchronicle@competitionpolicyinternational.com.

CPI ANTITRUST CHRONICLE MARCH 2018 & APRIL 2018

The March 2018 Antitrust Chronicle will focus on issues related to **China – Year of the Dog**.

Our topic for April 2018 will focus on issues related to **Hipster Antitrust**.

Contributions to the Antirust Chronicle are about 2,500 – 4,000 words long. They should be lightly cited and not be written as long law-review articles with many in-depth footnotes. As with all CPI publications, articles for the CPI Antitrust Chronicle should be written clearly and with the reader always in mind.

Interested authors should send their contributions to Sam Sadden (ssadden@competitionpolicyinternational.com) with the subject line "Antitrust Chronicle," a short bio and picture(s) of the author(s).

The CPI Editorial Team will evaluate all submissions and will publish the best papers. Authors can submit papers in any topic related to competition and regulation, however, priority will be given to articles addressing the abovementioned topic. Co-authors are always welcome.

I. PRIVATE EQUITY

PRIVATE EQUITY MEETS ANTITRUST… COMPLICATIONS ENSUE

BY KENT BERNARD[1]

1 Adjunct Professor, Fordham University School of Law; J.D. 1975, University of Pennsylvania; B.A. 1972 Colgate University. I want to thank Alyssa Black-Dorward and the staff of the Fordham Law Library for their research assistance.

I. INTRODUCTION

The term "private equity" sometimes seems to be more of an epithet than a description. Private equity is neither the shining savior of the American economic system, nor is it something that slithered up from the underworld. It is simply a way in which an investment entity is structured. The real debate is not over what private equity is, but rather what it claims to do when it acts differently from a traditional purchaser of stock or assets.

The truth is that when we talk about private equity in its "different" role, without raising our voices, there is general agreement as to the core concepts of the term: (a) an investment vehicle that is not publicly traded; which (b) acquires whole or partial interests in other companies; and (c) steers those companies through a transition period of (hopefully) performance improvement (which may involve reduction in the number of employees, asset sales, change in management and change in makeup of the Board of Directors); and (d) sells out (again hopefully) at a profit.[2] Typically private equity firms exercise influence over their portfolio companies through representation on the portfolio company boards of directors.[3] They seek to add value to the portfolio companies through financial, governance and operational engineering.[4] While there can be a dispute over whether a private equity firm actually *does* add value to companies in which it invests, it seems to be generally accepted that a private equity investment is usually a prelude to changes in the company in which the investment is made.

Antitrust gets involved because when a person or company, private equity or otherwise, owns all or a part of various companies that may compete with one another in their own markets, two sets of antitrust issues arise. First, the substantive rules of Section 7 of the Clayton Act prohibit the acquisition of stock or assets by any person (natural or corporate) where the effect may be a substantial lessening of competition.[5] This rule is tempered by an exemption from the statute for acquisition of such stock or assets "solely for investment,"[6] which is defined as "… not using the same by voting or otherwise to bring about or attempting to bring about, the substantial lessening of competition."[7] The case law is tolerably clear that if you are *not* seeking representation on the target board of directors, and are *not* able or seeking to become able to exert operational influence over the target, then even substantial equity investments may qualify for the Section 7 exemption.[8]

But Congress and the Agencies had two separate concerns. There was the substantive issue of a potentially adverse impact on competition (the Section 7 issue). But perhaps equally important was that the Agencies often had no notice of or ability to investigate transactions to determine if they would violate Section 7. There had been a wave of midnight acquisitions, which were done and closed before the government had adequate time to investigate (and perhaps challenge) them.

> The data suggest that close to 70% of the problematic mergers were not detected in time to seek preliminary relief. In these cases the parties could close the deal, integrate the assets, reap the profits – some illegitimate and some not – and pursue a protracted strategy of delay. There were strong incentives in favor of the midnight deal, and thus the odds were stacked against the antitrust enforcers.[9]

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2 See generally Barber & Goold, The Strategic secret of Private Equity, Harvard Business Review (September 2007), available at: https://hbr.org/2007/09/the-strategic-secret-of-private-equity.

3 Barber & Goold, supra note 2, at page 3.

4 Gompers, Kaplan & Mukharlyamov, What Do Private Equity Firms Say They Do? Harvard Working Paper 15-081 (2015) available at: http://www.hbs.edu/faculty/Publication%20Files/15-081_9baffe73-8ec2-404f-9d62-ee0d825ca5b5.pdf. The financial engineering can take the form of creating new financial incentives for the management team; governance engineering deals with control of the Board of Directors, and operational engineering can be the bringing of expertise gained through other companies and investments to bear on the current project.

5 Clayton Act Section 7; 15 U.S.C. Section 18.

6 Clayton Act Section 7; 18 U.S.C. Section 18; see also Dubrow, Challenging the Economic Incentives Analysis of Competitive Effects in Acquisitions of Passive Minority Equity Interests, 69 ABA Antitrust Law Journal 113, 115 (2001).

7 18 U.S.C. Section 18. See also Dubrow, supra note 6, page 115.

8 See, e.g. *Crane Co. v. The Anaconda Co.*, 411 F.Supp. 1210 (S.D.N.Y. 1975); *United States v. Tracinda Investment Corp.*, 477 F. Supp. 1093 (C.D. Cal. 1979)

9 Baer, Reflections on 20 Years of Merger Enforcement under the Hart-Scott-Rodino Act (speech before the Conference Board, October 1996; available at: https://www.ftc.gov/public-statements/1996/10/reflections-20-years-merger-enforcement-under-hart-scott-rodino-act.

That led to the enactment of the Hart-Scott-Rodino ("HSR") Act of 1976.[10] The HSR Act requires premerger filings, information disclosure and waiting periods to allow for the FTC or the Antitrust Division to investigate the transaction before it takes place.

The HSR Act has its own exemption for the acquisition of less than 10 percent of the issuer's outstanding voting securities, regardless of the value of those securities, if the acquisition is made "solely for the purpose of investment."[11] If an acquirer believes that it is exempt, it will not file. But in the absence of filings and disclosure, how are the enforcement agencies to plumb the depths of the acquirer's heart? Here the difference in potential harm between a violation of Section 7 and a violation of the HSR Act is mirrored by a distinction in the application of the remedy.

The Section 7 harm would occur upon the implementation of the acquisition (Section 1 covers everything before that). So if the transaction was enjoined and therefore never implemented, then there would have been no harm and accordingly there are no fines or civil penalties.

The HSR Act is fundamentally different. It is designed to give the enforcement agencies notice and time to review a transaction in order to determine whether to challenge it. It is enforced by civil penalties. A party cannot avoid those penalties simply by terminating the transaction if the agency comes calling. The violation occurred when the purchase was made without the required filings and notice period. Unwinding the deal stops the clock on further penalties, but does not wipe out any penalties that have already accrued. And those accrued penalties can be substantial.

II. THE EXEMPTIONS APPLIED

It is safe to say that the FTC and DOJ do not like the "solely for investment" exemption to the HSR Act, and view it as requiring a purity of heart that is very rare in the investment world. As Malcolm Pfunder (who, as Assistant Director for Premerger Notification at the FTC participated in drafting the implementation rules for the HSR Act) noted, the investment exemption means essentially that except for voting the shares, the acquirer must intend to remain wholly passive.[12] The acquirer must have no intention (and obviously must take no action) to participate in the formulation, determination or direction of the issuer or the business affected.[13] In other words, the acquirer can't do anything that private equity traditionally wants to do. It is sort of like letting a child have an ice cream cone, but only on condition that he not eat it.

That standard has not gotten any looser over the years since it was formulated. In 2015 the FTC Bureau of Competition revived a 1988 opinion in which the agency warned that if an acquirer was even seriously *considering* a possible takeover attempt of the target, but had not yet made any final decision either way, it was not buying stock "solely" for the purpose of investment.[14]

Indeed, something as basic as which SEC filing the acquirer makes can and will be used against it in a court of law.[15] The filing with the SEC of a Schedule 13D (as opposed to a Schedule 13G) may be taken as evidence of non-passive intent for the purposes of the exemption.[16] The FTC's aggressive approach to limiting the application of the exemption may seem harsh, but is supported by the reasons underlying the HSR Act. The agencies want to learn about these transactions, and review them, before they come effective. From that perspective, possible over inclusiveness is a forgivable sin.

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10 15 U.S.C. 18a.

11 15 U.S.C. Section 18a(c) (9); 16 C.F.R. Section 802.9. Note that if the value of the transaction is below the HSR jurisdictional threshold, there is no filing requirement regardless of the buyer's intent. The statute simply is not triggered.

12 Pfunder, Shareholder Activism and the Hart-Scott-Rodino Act Exemption for Acquisitions of Voting Securities Solely for the Purpose of Investment, Antitrust (Summer 2008) 74. The agencies had to allow for voting of the shares, given that the statute speaks in acquiring them as an investment. It would be an odd investment that had a ban on voting the shares.

13 Idem.

14 Feinstein et al., "Investment-only" means just that...., FTC News Release (August 24, 2015), available at: https://www.ftc.gov/news-events/blogs/competition-matters/2015/08/investment-only-means-just.

15 Apologies to *Miranda v. Arizona*, 384 U.S. 436 (1966).

16 Schedule 13D covers active investors, whereas 13G is meant to passive investors. See Novaworks LLC, Quick Guide: Schedule 13D vs. Schedule 13G (2015), available at: https://www.novaworkssoftware.com/blog/archives/38-Quick-Guide-Schedule-13D-vs.-Schedule-13G.html. See also Nili, The HSR Act's Investment-Only Exemption for Targets and Activist Investors, The Harvard Law School Forum on Corporate Governance and Financial Regulation (2015), available at: https://corpgov.law.harvard.edu/2015/02/23/the-hsr-acts-investment-only-exemption-for-targets-and-activist-investors/; Pfunder, supra note 12, page 75.

For example, Kinder Morgan and Magellan competed in providing gasoline and petroleum terminal services. When Carlyle and Riverstone Holdings, an investment group that owned a 50 percent interest in Magellan, attempted to acquire a 22.6 percent interest in Kinder Morgan, the FTC challenged the transaction. The FTC alleged that although Carlyle and Riverstone did not have a majority stake in either company, their joint ownership interests would give them material control over the competing firms. They might seek representation on both companies' boards, and/or exercise a veto power at Magellan. The case was settled by a consent decree that required the acquirer (Carlyle) to remove its agents from the Magellan board, and prevented the firms from attempting to control or influence Magellan's operations.[17]

Sometimes the harm is less hypothetical. In 2011 three Third Point LLC funds made multiple acquisitions of Yahoo voting securities that exceeded the applicable HSR thresholds. Third Point did not make HSR filings in connection with those acquisitions, arguing that the shares were acquired for "investment only" and therefore exempt from the filing requirements. However in the period before Third Point made remedial HSR filings, it (a) contacted individuals to gauge their willingness to become CEO or a board member of Yahoo; (b) assembled a slate of potential directors for the board of Yahoo; (c) drafted correspondence to Yahoo announcing that Third Point was prepared to join the Yahoo board; (d) stated publicly that it was prepared to propose a new slate of directors at Yahoo's next annual meeting, and (e) internally discussed possibly launching a proxy fight to change the Yahoo board composition. The parties settled for injunctive relief only (it was Third Point's first bite at that apple), but the FTC set out a laundry list of actions that were prohibited if Third Point wanted to rely on the "investment only" exemption in the future. Not surprisingly, items (a) through (e) were all on that "banned" list.[18]

In *Third Point* the FTC reiterated that the "investment only" exemption is a very narrow gate. Any attempt or request to join the target's board immediately slams that gate shut, leaving you outside of the exemption, as Biglari Holdings discovered to the tune of an $850,000 civil penalty settlement.[19] Perhaps it is the fact that all of the cases have settled that leads investors to keep pushing to see how far they can stretch the idea of a "passive" investment. In 2016 Value Act Capital was hit with a DOJ Complaint seeking $19 million for the failure to properly file and wait under the HSR Act. Value Act purchased over $2.5 billion in stock of Halliburton and Baker Hughes after those companies had announced a merger. Value Act did not file under the HSR Act, nor did it observe any waiting periods. Rather, it relied on the "investment only" exemption, and it looked as if this one might go to trial. No such luck. Value Act settled for $11 million.[20] Of course, the fact that the fine for HSR violations had increased from $16,000 per day to $40,000 per day, and that the new fine applied to violations occurring before it's effective date, might have had something to do with the election to settle.[21] So while there still has not been any court decision endorsing the narrow interpretation of the exemption taken by the enforcement agencies, only a brave or foolhardy investor would challenge the core elements of the doctrine of "no board seats" and "no influencing management."

III. PARTIAL ACQUISITIONS

If a person holds a share in one company and acquires a share in a competing company, the question of influence or control doesn't just go to whether the stock ownership is strictly "for investment" under Section 7 and the HSR Act, but whether any coordination of the activities of the two subsidiaries could be treated as a Section 1 violation. While HSR violations can implicate big fines, Section 1 violations are felonies that carry jail time. But if the shares in the two subsidiaries are truly held purely for the sake of investment, can that ownership (exempt from Section 7) still create a violation of Section 1?

Since most cases deal with active participation by the common owner, the issue of the application of Section 1 to an acquisition that is exempt from Section 7 and the HSR Act as strictly passive seldom arises. Logically (and logic isn't always the winner here), if the investment

17 See Keyte & Schwartz, Private Equity and Antitrust: A New Landscape, Antitrust (Fall 2016) 21. See also: https://www.ftc.gov/news-events/press-releases/2007/01/ftc-challenges-acquisition-interests-kinder-morgan-inc-carlyle.

18 *United States of America, Plaintiff, v. Third Point Offshore Fund, Ltd.; Third Point Ultra Ltd.; Third Point Partners Qualified L.P.; and Third Point, LLC, Defendants*, (1:15-cv-01366) (D.DC. 2015). The filings are collected at: https://www.ftc.gov/enforcement/cases-proceedings/121-0019/third-point-llc.

19 See, e.g. *United States v. Biglari Holdings*, (1:12-cv-01586) (D.DC. 2013). The filings are collected at: https://www.ftc.gov/enforcement/cases-proceedings/1110224/biglari-holdings-inc.

20 *United States v. VA Partners et al.*, (16-cv-01672) (N.D. Cal. 2016). The filings are collected at: https://www.justice.gov/opa/pr/justice-department-obtains-record-fine-and-injunctive-relief-against-activist-investor.

21 See Nigro, ValueAct Settlement: A Record Fine for HSR Violation, The Harvard Law School Forum on Corporate Governance and Financial Regulation (2016), available at: https://corpgov.law.harvard.edu/2016/07/19/valueact-settlement-a-record-fine-for-hsr-violation/. See also, Justice Department Obtains Record Fine and Injunctive Relief against Activist Investor for Violating Premerger Notification Requirements, Press Release (July 12, 2016), available at: https://www.justice.gov/opa/pr/justice-department-obtains-record-fine-and-injunctive-relief-against-activist-investor.

is truly passive, none of the concerns raised by the enforcement agencies should apply. The activity that concerns us, such as coordinating the actions of the partially owned subsidiaries, or even acting as a conduit for information exchange between the subsidiaries, would by themselves take the ownership out of the "solely for investment" exemptions. If the two subsidiaries are wholly (or majority) owned, they are treated as one with the parent for Section 1 purposes. But to get there, and exercise control once there, the actions of the investor necessarily take the investment outside of the exemption. Filing and waiting (or risking a hefty fine) seems almost inevitable.

IV. OTHER THINGS TO KEEP IN MIND

A. Section 8 of the Clayton Act

Most antitrust lawyers have at least a passing familiarity with Section 8 of the Clayton Act, known commonly as the interlocking directorates provision.[22] It deals with one person (natural or corporate) serving as the director of two corporations that compete with one another [23] such that the elimination of competition between them by agreement would violate the antitrust laws.[24] Like Section 7, Section 8 is an incipiency statute, designed to "nip in the bud" potential violations by removing the opportunity (or temptation) to such violations arising from interlocking directorates.[25] Section 8 has certain jurisdictional thresholds which are adjusted each year.

The key thing to remember for our purposes is that even if the interlock is exempt from liability under Section 8, Section 1 of the Sherman Act (and Section 5 of the FTC Act) still apply to prohibit collusive behavior or information sharing among competing companies.[26] The limits on the interlock prohibition, like the exemptions from the HSR filing requirements, are not a blank check for anticompetitive conduct after or during the acquisition.

B. The SEC: What You File and How It Can and Will be Used

Although we focus on antitrust, we touched on the SEC filing issue earlier. When judging the intentions of a shareholder (whether to influence management or to be strictly passive), one key piece of evidence is whether the shareholder files a form 13G or a form 13D with the SEC. A Schedule 13G is a beneficial ownership disclosure statement intended for passive investors who own less than 20 percent of a public company's outstanding shares. A passive investor is considered one who does not intend to exert control over, or seek change in, the company invested in.[27] Even if there is no intent to exercise control, the very ability to exercise such control, or to directly or indirectly influence the management of the issuer, makes the issuer's officers and directors ineligible to file on Schedule 13G.[28]

What the antitrust agencies have taken away from this is that a shareholder's decision to file a schedule 13D, strongly suggests at least a potential activist intent.[29] To the FTC, an investor would not file a 13D (indicating that she might seek control of the target at a later date, and that while she had no present plans to merge with, reorganize or liquidate the target, she might formulate such plans in the future) if the investment were truly passive under the antitrust rules.[30] There is no "Let me be exempt now and I will file if and when I decide to influence the company" clause here. Although there is a provision under the HSR Act that acquisition of non-voting convertible stock may not be a reportable transaction,

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22 15 U.S.C. Section 19(a). See Keyte & Schwartz, supra note 17, page 25. See also, ABA Antitrust Law Developments pages 436-440 (7the Ed. 2012).

23 See Keyte & Schwartz; supra note 17, pages 25-26.

24 15 U.S.C. Section 19(a) (1) (B).

25 *U.S. v. Sears Roebuck & Co.*, 111 F. Supp. 614, 616 (S.D.N.Y. 1953).

26 See generally Wagoner, Interlocking Board Members and Officers: What You Need to Know (Shumaker Loop & Kendrick) (July 27, 2017), available at http://www.lexology.com/library/detail.aspx?g=0a122efb-7e60-4560-a416-39ed51c3867b.

27 SEC Compliance and Disclosure Interpretations, Guidance Regulation 13d, Exchange Act Section 13(d) and 13(G) and Regulation 13D-G Beneficial Ownership Reporting, Question 103.4 (2016) available at: https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm.

28 SEC Guidance, supra note 27.

29 Pfunder, supra note 12.

30 See Nili, supra note 16, page 2. See also Aronson et al. Interpretation of Antitrust Exemption at Heart of DOJ Action Against ValueAct, Skadden Insights (April 8, 2016), pages 2-3, available at: https://www.skadden.com/insights/publications/2016/04/interpretation-of-antitrust-exemption-at-heart-of.

and that the conversion into voting shares is the reportable acquisition that may require filing and waiting,[31] there is no parallel two-step process that would allow voting shares to be acquired without a filing and only trigger, a filing requirement when the investor implemented changes in the target. An investor cannot claim to be passive for the purposes of availing itself of an antitrust exemption while at the same time being potentially activist in its securities law filings.

What all of this cross-confirms is that the very narrow path to avoiding the need for antitrust filings (and waiting periods) is unlikely to be available to a private equity fund in its capacity as an investor in other companies. And this is further reinforced by a totally separate statutory structure that would not normally trigger an antitrust lawyer's alarm bells.

C. Say Hello to ERISA

There is one further twist in the complex world of antitrust and private equity, and it is a beauty. We have seen that private equity would prefer to go about its business without having to make filings and undergo antitrust reviews. And we have seen that there is indeed a way to avoid filing and waiting, but only if the investment is truly passive, and the investor does not have even the right to interfere with the management of the company in which it is invested.

Many private equity funds have limited partners that are pension plans, or other vehicles subject to the Employee Income Retirement Security Act ("ERISA").[32] ERISA is an enormously complex field of its own. By having ERISA benefit plans as limited partners, the assets of the private equity fund will be considered "plan assets" subject to all of the rules and regulations of ERISA unless the fund can come under an ERISA exemption. The exemption of choice seems to be the so-called Venture Capital Operating Company ("VCOC") exemption.[33]

But this creates a problem. While a full discussion of the VCOC is light years beyond the scope of this article, the key point for our purposes is that under the VCOC exemption, the fund must have or obtain management rights in the company in which the investment is made. But having such control over the company takes the investment out of the "solely for the purpose of investment" HSR exemption. To avoid the ERISA, you almost are required to walk face first into the HSR brick wall.

V. CONCLUSION

The dilemma faced by a private equity firm here can be simply summarized:

> The FTC's narrow interpretation of the investment-only exemption has been a significant restriction for activist investors because they cannot both move quickly to gain a substantial position in an issuer (by availing themselves of an HSR exemption) and attempt to influence the issuer's behavior.[34]

The problem is that the business model of at least a large part of private equity is activist. It attempts to come in, improve the company, and get out again. Passive investment, this is not. But this is only one of the issues. We have noted earlier that the SEC requires the filing of a Schedule 13D if the acquirer has the intent to take certain actions. But conceding the possibility of that intent for SEC purposes may be read as conceding it for HSR purposes as well, and thereby making the "investment only" exemption inapplicable.[35] To be honest about what you intend to do, may make it impossible to get that done. It is indeed, a puzzlement.[36]

31 See 16 C.F.R. 802.31 and 801.32.

32 29 U.S.C. Chapter 18; Johnson, The VCOC Exemption and Initial Fund Investments, Taft Private Equity Insight (2016) available at: http://www.taftprivateequitylawinsight.com/2016/03/the-vcoc-exemption-and-initial-fund-investments/. See also The U.S. Private Equity Fund Compliance Guide, Chapter 14 (by S. John Ryan) (2010) available at: http://www.sewkis.com/files/Publication/f1d7efed-2e02-4382-a055-798a915cff65/Presentation/PublicationAttachment/23a9ff38-321d-4211-b922-79b854f8f045/The%20US%20Private%20Equity%20Fund%20Compliance%20Guide%20-%20Chapter%2014.pdf.

33 Johnson, supra note 32; Wilkinson and White, Private Equity: Antitrust Concerns with Partial Acquisitions, Antitrust 28, 29 (Spring 2007); Ryan, supra note 32, pp. 152-153.

34 Aronson et al., Interpretation of Antitrust Exemption at Heart of DOJ Action Against ValueAct, Skadden Insights (April 8, 2016), available at: https://www.skadden.com/insights/publications/2016/04/interpretation-of-antitrust-exemption-at-heart-of.

35 See Nili, supra note 16; see also Aronson, supra note 30.

36 Rogers & Hammerstein, The King and I, song by the King of Siam, "A Puzzlement" (1951).

Avoiding the need to make an HSR filing for a private equity investment is proving to be difficult. So why not just file and wait? In the case where a private equity fund is targeting a single company, and where it is not interested in competing companies, a filing should clear quickly. To the argument that the need to file and wait delays the ability to improve the target and increase shareholder value, claiming that the investment is wholly passive and exempt doesn't simply delay the ability to act, it blocks it completely. If the private equity fund is making investments in companies that do compete with each other, the antitrust analysis is less clear cut.[37] But where there are investments in competing companies, it may be harder to convince a skeptical FTC that all of those investments are truly passive.

37 See the debate between O'Brien and Salop on one side, and Dubrow on the other. O'Brien & Salop, Competitive Effects of Partial O'Brien & Salop, Reply, 69 Antirust L.J. 611 (2001).

PRIVATE EQUITY AND MERGER CONTROL – THE RULES OF THE GAME ARE CHANGING

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I. INTRODUCTION

The merger control assessment for transactions involving private equity firms ("PE firms") has become increasingly complex as, over the years, they have grown to become industry giants, controlling a large number of portfolio companies with a well-established industry presence.

As to the establishment of filing requirements, in most cases this requires a thorough assessment of the control structure of the fund involved in the transaction in order to identify the relevant turnover for the merger filing analysis.

As to the substantive assessment, the main complexity derives from the need to cover any potential horizontal overlap, but also vertical relationship between the PE portfolio companies and the target. In fact, PE firms typically control a large number of portfolio companies and there is a tendency to focus investments in clusters or specific sectors. Moreover, PE transactions often have a clear industrial rationale driven by pre-existing portfolio companies, and do not constitute a mere financial investment.

For well-established PE firms, an upfront merger filing analysis, including the substantive review, has become an essential part of the overall deal, including – in certain cases – to establish whether (and to what extent) remedies will be needed to obtain timely clearance.

II. THE RELEVANT ENTITIES TO ASSESS MERGER CONTROL FILINGS

Transactions involving PE firms are often subject to merger control requirements because their turnover exceeds the relevant thresholds and normally result in a change of control over a target, which triggers filings.

In most of the cases, to establish whether a competition authority has jurisdiction over a transaction the relevant turnover to be taken into account will be the financial income of the PE firm and the revenue generated by all its controlled portfolio companies, which are deemed to be part of the same "group."

The EU Commission's Jurisdictional Notice describes control as the "power to determine strategic commercial decisions"[2] of another undertaking, so-called "positive control," or the power to veto such decisions, i.e. "negative control." In this regard, the Jurisdictional Notice provides guidance on transactions involving investment funds.

As a general remark, the Jurisdictional Notice notes that "[i]nvestment funds are often set up in the legal form of limited partnerships, in which the investors participate as limited partners and normally do not exercise control, either individually or collectively."[3] As such, investment funds tend to acquire shares and voting rights that confer control over portfolio companies in their capacity as mere investment vehicles. Control as such is then ordinarily exercised by the investment company that has set up the fund, not the fund itself, through the investment group's organizational structure, e.g. by controlling the general partner of the funds and/or by contractual agreements, such as advisory agreements. In that way, the investment company generally acquires at least indirect control over the portfolio companies held by the investment funds.[4]

III. IS EACH PE FIRM DIFFERENT?

Although the Jurisdictional Notice provides some general guidance, the structures that involve investment funds will be assessed on a case-by-case basis.

- First, PE firms are often organized through different funds, and each of these funds controls a number of portfolio companies. In some cases, it could be argued that the fund involved in the transaction is not part of the same "group" of the other funds, and that therefore these should not be taken into account both for turnover purposes and for the substantive assessment. To support such a position, it may be helpful to show that funds within the same PE firm are managed by different general partners. However, this may not be sufficient to persuade the EU Commission (and other competition authorities) if, for instance, the same managers are board members of

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2 Commission Consolidated Jurisdictional Notice under Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings, OJ C 95 of 16.04.2008, ("Jurisdictional Notice"), para. 54.

3 Jurisdictional Notice, para. 15.

4 Jurisdictional Notice, paras. 189 to 191.

different general partners established by the PE firm or if the general partners are supported (or supervised), for instance, by the same investment committee or advisory committee. Also, we note that by structuring each fund independently, and by taking this position before competition authorities, PE firms would have to carefully implement effective safeguards to avoid any coordination and exchange of competitively sensitive information between the funds and portfolio companies controlled by the different funds. This may increase the risk of Article 101 TFEU infringements.

- Second, in a few cases there may be a limited partner holding more than half of the limited partnership of the fund. This may be the case for a large institutional investor. Although it is unlikely that the limited partner exercises any controlling rights over the investment fund, its turnover would still be relevant to establish merger filing requirements.

- Third, there is an increased tendency in the public sector – for instance in China and in the Gulf area – to establish investment funds acquiring controlling stakes in European companies. Although these investment funds may be set up in the legal form of limited partnerships, public authorities may still exercise (indirect) control over the fund. Any link between the management of the fund and the public authorities may raise questions as to the possibility for the State to exercise decisive influence over the fund. In addition, having a public entity (alone or together with other public entities) acting as a limited partner – especially in cases with a large shareholding in the limited partnership – may also raise questions as to the independent exercise of investment and other strategic decisions by the fund. In short, a case-by-case analysis is needed to establish whether the investment fund shall be viewed as a State-Owned Entity, to which specific merger control rules may apply.

These examples show that considering all funds (and their respective portfolio companies) as part of a single economic entity for merger control purposes may not necessarily reflect the actual structure of a PE firm. That said, there are a few jurisdictions (e.g. United States and Canada) diverging from this approach: in these jurisdictions merger control rules are applied to the fund(s) involved in the transaction being assessed, rather than to the PE "group."

IV. ACQUISITION OF CONTROL

The notion of control encompasses rights, contracts or any other means which, either separately or combined, confer decisive influence on an undertaking. Under Article 3(2) of the EUMR,[5] this is particularly the case when the possibility of exercising decisive influence is the result of (a) ownership or right to use all or part of the assets of an undertaking, or (b) rights or contracts that confer decisive influence on the composition, voting or decisions of the organs of an undertaking.

The PE firm will typically acquire sole control over a target by acquiring (a) the entire capital, (b) a majority interest, or (c) a minority shareholding, which confers veto rights over the target's strategic decisions. Veto rights resulting in (negative) joint control relate to decisions on matters such as the target's budget, business plan, major investments or appointment of senior management.

In other cases, the PE firm will acquire joint control over the target, either together with another PE firm or institutional investor or together with pre-existing shareholders or the founders of the target. First, the acquisition of joint control increases the likelihood of merger filing requirements. Second, the assessment of whether the PE firm will be acquiring joint control requires a case-by-case analysis, which would be conducted both on a *de jure* basis and a *de facto* basis, in particular when the founders are still involved – as shareholders and/or as managers – in the business of the target.

Finally, we note that even the acquisition of a minority stake above a certain percentage, without any controlling rights, may trigger filings in EU Member States (e.g. Germany and Austria) and in extra-EU jurisdictions.

5 Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings, OJ L 24, 29.1.2004, ("EUMR"), pp. 1–22.

V. RECENT PROCEDURAL DEVELOPMENTS

A. The EU Commission's Consultation on EU Merger Control

In October 2016 the EU Commission launched a public consultation on Evaluation of procedural and jurisdictional aspects of EU merger control, seeking stakeholders' feedback on procedural and jurisdictional aspects of EU merger control.[6] Two aspects of this consultation are of particular interest for PE transactions.

- The EU Commission is contemplating the introduction of a deal size threshold, complementary to the current turnover thresholds. A likely consequence of the additional threshold is that more transactions would be caught at the EU level, resulting in additional burdens for PE firms, especially for those investing in new technology businesses.

- The EU Commission is also considering extending the scope of application of the EU merger control simplified procedure. Broadening its application to transactions involving a vertical relationship and to acquisitions of joint control over a target with no activities within the EEA territory would contribute to a reduction of the burden on PE firms involved in transactions which do not present substantive issues.

B. Enforcement Against Procedural Violations of Merger Control Rules

Under the EUMR, as in most jurisdictions, the parties acquiring control in a transaction which meets the jurisdictional thresholds, are required to notify the EU Commission, and are subject to a standstill obligation, i.e. must not implement the transaction before clearance.[7] The EU Commission can impose fines of up to 10 percent of worldwide group turnover for intentional or negligent breaches of such obligation.[8] With the EU Commission (and other competition authorities in Member States and worldwide) cracking down on breaches of gun-jumping rules and of the standstill obligation (see e.g. the ongoing investigations in Case M.7993, *Altice/PT Portugal* and Case M.8179, *Canon/Toshiba Medical*), PE firms must carefully assess their filing obligations and ensure they obtain clearances prior to completing their transactions or exercise any control over the target companies.

Moreover, the EU Commission can also impose fines of up to one percent of worldwide group turnover for intentionally or negligently supplying incorrect or misleading information in the context of merger control filings, regardless of whether the information had any impact on the EU Commission's decision.[9] The EU Commission is also actively enforcing its powers in this context (see e.g. the fining decision in Case M.8228, *Facebook/WhatsApp* and the ongoing investigations in Case M.8181, *Merck/Sigma-Aldrich* and Case M.8436, *General Electric/LM Wind*), and it recently stressed the importance of complying with the obligation to provide correct information, in order for the EU Commission to be able to take decisions "in full knowledge of accurate facts."[10] Therefore, it is crucial for PE firms, as notifying parties, to ensure that information provided by all the parties involved in the transaction, including the portfolio companies and the target, is accurate and complete.

6 Invest Europe, the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors, submitted its observations.

7 EUMR, Articles 4(1) and 7(1).

8 EUMR, Article 14(2).

9 EUMR, Article 14(1).

10 European Commission Press Release, IP/17/1369.

VI. THE SUBSTANTIVE ASSESSMENT AND POTENTIAL REMEDIES

The EU Commission's Guidelines on the assessment of horizontal mergers[11] and Guidelines on the assessment of non-horizontal mergers[12] provide a useful framework for the assessment of substantive competition issues. The same principles and tests apply to PE transactions.

The large majority of PE transactions still do not present substantive issues, i.e. with no (or limited) overlaps with the target's activities. However, PE firms' increasingly large portfolios may trigger competition issues. The rules of the game have changed for PE firms involved in controlled auctions: in the past, the absence of any competition issues was often an advantage for PE buyers, while today, overlaps with other portfolio companies are more frequent, and industrial bidders may have an advantage.

This evolution requires PE firms to conduct an in-depth assessment of the potential horizontal overlaps and vertical links between the target and the portfolio companies. In cases where the PE firm controls a large number of portfolio companies active in the sector of the transaction, the data gathering process may prove to be very burdensome. Moreover, in cases in which a PE firm is contemplating joint control together with a co-investor (for instance, another PE firm), the assessment of horizontal overlaps and vertical links must be extended to the co-investor's activities and its portfolio companies.

Therefore, it is recommended that this analysis be conducted up front, leading – in case of competition concerns – to the possibility to propose upfront remedies, especially in deals where time is of the essence. Competition authorities usually welcome informal remedies discussions at the early stage of the notification process (and even during the pre-notification phase, where applicable). Such early discussions increase the chances of obtaining a conditional clearance (i.e. subject to remedies) in Phase I and mitigate the risk of competition authorities opening lengthy in-depth (Phase II) investigations. We note that negotiating a remedy package in Phase II may also increase the risk for PE firms of having to divest certain assets, or an entire business, under time pressure and with limited bargaining power, without getting the full value of the remedy package.

In transactions with a clear rationale to consolidate the business of one of the portfolio companies, it could in theory trigger a "conflicting interest" between the PE firm and the portfolio company, with the PE firm being typically more risk adverse on competition issues than its portfolio company.

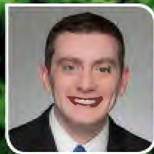
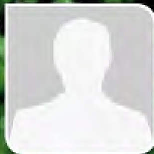
VII. CONCLUSION

PE firms now need to take a more strategic approach to merger control issues. In the past, PE transactions typically did not raise any competition issues, but now – due to their increasingly large portfolios – PE firms need to be pro-active in conducting merger control analysis prior to initiating a transaction. Having a good understanding of filing requirements and substantive issues (if any) is crucial in coming up with a plan to fix these issues up front, in order to avoid falling into lengthy Phase II investigations and to be able to close transactions without undue delay.

11 Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, OJ C 31, 5.2.2004, pp. 5–18.

12 Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings, OJ C 265, 18.10.2008, pp. 6–25.

FOCUSING ON PRIVATE EQUITY: GLOBAL MERGER CONTROL IMPLICATIONS

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I. INTRODUCTION

Cross-border mergers and acquisitions surged to a 10-year high in 2017, with billion-dollar deals increasing by 14 percent over 2016, necessitating merger control clearances worldwide. Contributing substantially to this uptick, private equity firms took starring roles as principal investors, consortium members or as sources of financing. In each such transaction, private equity firms and their advisors must evaluate their potential merger control filing obligations in more than 160 jurisdictions. While each jurisdiction approaches merger control differently, private equity firms, in contrast to companies, typically face a common set of challenges across the globe due to their complex governance structures, extensive portfolio holdings and myriad investment structures. This article will discuss key global competition updates and considerations for private equity firms, including:

- Definitions of "control" and divergent views regarding a private equity firm's economic group;
- Calculations of turnover, including for jointly controlled companies;
- Global developments in merger control, including major regime changes, focusing on transactions with minimal nexus to a jurisdiction; and
- Increased disclosures specifically for private equity firms in certain jurisdictions.

As such, private equity firms must be conscientious when analyzing filing obligations globally. Deliberate or accidental failure to submit mandatory notifications may result in costly penalties – both financial and reputational. With the ever-increasing scope of mandatory filing requirements, private equity firms must evaluate compliance in jurisdictions despite limited target presence or where the parties previously have not filed. Given the recent focus on technology, pharmaceutical and other start-up markets, where established regimes are reconsidering traditional turnover-based measures as the sole indicator of market presence, private equity firms must be cognizant of how their portfolio companies and acquisition targets may impact a particular market even though the revenue may be negligible.

II. EVALUATING JURISDICTIONAL THRESHOLDS

Navigating the merger control criteria for all relevant jurisdictions can be difficult not only because the rules are constantly changing, but also because the regimes often have varying approaches to similar concepts. Consider the simplest example – a private equity fund purchasing all of the voting stock of a target. Many jurisdictions use a two-part turnover test to determine whether a filing is necessary, analyzing the turnover of the acquiring party and its economic group on the one hand, and the turnover of the target on the other. This is largely where the similarities end, however, as jurisdictions have diverging definitions for the concepts of control, turnover and the calculation of turnover.

A. "Control" and the "Economic Group"

Assuming that a particular deal qualifies as a notifiable transaction under local law – a merger, share purchase, asset purchase or an amalgamation, depending on the jurisdiction – the parties involved must determine whether an acquiring party or parties will ultimately gain control over the target. Further complicating matters, many jurisdictions lack a target-specific threshold, only requiring that at least two parties exceed the given thresholds. This is particularly critical for private equity firms using bidding consortia to bear in mind because the European Union Merger Regulation, along with many other jurisdictions, can be triggered by two sponsors, both of whom meet the jurisdictional thresholds in the EU, obtaining control of an entity that does not have revenues in the EU.

With respect to a private equity firm, the relevant turnover typically consists of that generated by funds under common management and their controlled investments. Consider, however, the differences between the definitions of "control" in the U.S., Canada, the European Union, Brazil and China:

- In the United States, "control" is a bright-line test under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended ("HSR Act"). Control of a non-corporate entity means having the right to at least 50 percent of the profits, or upon dissolution, assets of such entity, whereas control of a corporation means ownership of at least 50 percent of its outstanding voting securities or having the present contractual right to designate at least half of its board of directors. In an acquisition context, the entity which controls the acquiring entity and is not controlled by any other entity or person is the ultimate parent entity ("UPE"). In determining whether jurisdictional thresholds

are met one looks to the turnover of the UPE and its controlled entities. Because of the very specific economic test of control, a private equity fund is often its own UPE even though the fund may be one of several sister entities all of which are engaged in investing and are commonly managed by the same general partner.

- In Canada, "control" likewise has a bright-line definition, which is similar to the definition in the United States. Control of a non-corporate entity means having the right to *more than* 50 percent of the profits, or upon dissolution, assets of such entity, whereas control of a corporation means ownership of more than 50 percent of the outstanding voting securities. Similar to the United States, a fund is often its own UPE. Typically, a fund will need to obtain information on the assets and revenues of the fund's worldwide "affiliates," which are typically issuers or entities owning or of which it owns more than 50 percent.

- In the EU, "control" is a more fluid concept, focusing on whether an entity exercises "decisive influence" through rights, contracts, or other means. Generally, these other means may include positive or negative control rights over key business decisions such as the budget, business plan, major investments or the appointment or dismissal of senior executives. Often, a fund's general partner (or ultimate general partner) exercises "decisive influence" over a private equity fund and certain of the fund's portfolio companies because the general partner makes the binding investment decisions for the fund the strategic decisions of the portfolio companies. In gathering turnover data, the firm must typically look across funds and their controlled portfolio holdings, the "economic group."

- In Brazil, while there is no explicit definition of "control," the Administrative Council of Economic Defense ("CADE"), the Brazilian competition authority, broadly views control as the ability to interfere/influence the commercial strategy of a company. Despite this somewhat amorphous standard, Brazil recently clarified that for private equity funds, only 50 percent holders of the fund are included in the same economic group as the fund itself for purposes of the thresholds assessment. As a result, in the context of a typical private equity fund that is widely-held, an economic group will consist of the fund and its 20 percent or greater owned entities, effectively severing the holdings of commonly managed funds.

- China's Anti-Monopoly Law also does not define "control." Instead, the Ministry of Commerce ("MOFCOM"), the Chinese authority charged with reviewing merger notifications, analyzes all facts including a party's contractual rights. While the result of this analysis is usually directionally consistent with that of the EU, MOFCOM has recently announced that it plans to issue definitive guidance on control, perhaps as early as this year. As with the EU, often the general partner (or ultimate general partner) of the investing fund is the controlling person and turnover will capture all controlled companies across funds that are under common ultimate management.

These varying approaches to control yield widely different results in a given merger control assessment. Consider the example of an alternative investment vehicle ("AIV") of a fund, an entity separate from the main partnership where a portion of the investor's capital is invested through the AIV for regulatory or tax purposes. Assume that the AIV in question is an entity which replicates the ownership of the fund but is not a subsidiary of the fund:

- In the U.S., under the very technical HSR definition of control, the AIV is likely its own UPE because there is no one with the requisite economic rights to at least 50 percent of the AIV, despite being commonly managed or sharing the same general partner;

- In Canada, whether an AIV is aggregated with the fund may depend on various factors, such as the distribution of interests in the AIV and the fund, as well as the structure of the transaction;

- In the EU, the AIV and the fund are typically considered to be part of the same economic group if the same ultimate general partner is making or has the right to make decisions for both; and

- In Brazil, generally the AIV is likely to be separate from the fund due to the recent changes with respect to control and investment funds.

For private equity firms, such divergent outcomes clearly impact whether jurisdictional thresholds are met across the globe and illustrate the importance of structure in private equity deals.

B. Calculation of "Turnover"

In the simplest of transactions – one buyer acquiring all of the voting securities of a single target – the relevant turnover of the acquirer is that of its economic group. Various jurisdictions, however, approach the calculation of turnover differently:

- Jointly-controlled entities: Where an entity shares control over a portfolio company with another shareholder, including, for example, in the EU where two shareholders may both be able to exercise "decisive influence" over a portfolio company, jurisdictions may attribute all or part of the company's turnover to each of its controlling shareholders. In jurisdictions such as Germany and Austria, the turnover generated by each controlling shareholder shall include 100 percent of the portfolio company's turnover. In the EU (under the EU Merger Regulation), in most circumstances a controlling shareholder that exercises joint control may apportion the turnover of the portfolio company based on the number of parties with which it shares control (e.g. where there are two controlling shareholders, 50 percent of the portfolio company's turnover would be attributed to each of the controlling shareholders).

- Affiliate or minority holding turnover: A couple of jurisdictions take into account the turnover of minority holdings when calculating total turnover for the economic group. For instance, in Austria local turnover generated by 25 percent or greater investments may be included in the economic group, regardless of whether the notifying party has "control" or exercises decisive influence over the particular portfolio company. Similarly, in Brazil the economic group for which the turnover is calculated includes all investments of at least 20 percent.

- Additions and subtractions: Many jurisdictions take divergent views on the mechanism for which parties must account for new investments and recent divestitures, including those taking place partway through the most recently-completed annual period. Due to the nature of the business, private equity companies must pay particular attention to when the purchase or sale of a portfolio company may alter the relevant turnover figures used to identify whether jurisdictional thresholds are tripped in any particular country.

Regardless of how a jurisdiction defines control for purposes of determining whether merger control filing thresholds are satisfied, many, if not all, will take a broader view of the group when conducting a substantive antitrust analysis.

III. UPDATES IN JURISDICTIONAL THRESHOLDS, PENALTIES AND DISCLOSURES

As regimes, even established ones, evolve and reevaluate prior policies and procedures to keep up with an ever-changing global economy, business models, and burgeoning industries, it is vitally important to keep abreast of changes. Small changes to jurisdictional thresholds, penalties, or disclosure requirements can significantly impact even the most sophisticated and veteran filer.

In the last several months, there have been significant changes and developments across the world:

- In the United States, the Premerger Notification Office ("PNO") of the Federal Trade Commission ("FTC") reversed its longstanding guidance with respect to Item 4(c) and Item 4(d) documents that address only foreign markets. Now, citing the increasingly interconnected global marketplace, the PNO requires parties to include such documents as responsive, thereby increasing the disclosure burden of filers. Additionally, the FTC recently increased the maximum allowable daily fine for a failure to notify under the HSR Act. The fine, which was $16,000 per day of non-compliance in 2016 and years prior, is now in excess of $40,000 per day.

- The EU and its Member States have long debated changes to merger control thresholds to address concerns regarding the ability of the European Commission ("EC") to review and evaluate all transactions that may lead to competition concerns, including minority transactions and those involving entities with low turnover that may not meet the technical jurisdictional thresholds. In response to Facebook's $22 billion acquisition of WhatsApp in 2014, the EC raised concerns that transactions involving technology start-ups, or other transactions whereby one party does not meet the turnover requirements in the EU, could nonetheless substantially effect competition in the EU. Further, the EC explored imposing a "size of transaction" jurisdictional threshold designed to capture large-scale mergers or acquisitions with a nexus to the EU that otherwise may not meet the existing revenue-based thresholds. Although the EC has yet to formally propose any changes, both Germany and Austria recently enacted similar amendments that are certain to increase the number of reportable transactions in those jurisdictions.

- A recent amendment to Germany's Act Against Restraints of Competition took effect on June 8, 2017, adding a size of transaction ("SOT") test to the German merger control regime. Although principally aimed at transactions involving start-ups, this new rule does not target specific industries. Under the new legislation, transactions are reportable in Germany if (1) the combined worldwide turnover of the

parties exceeds EUR 500 million; (2) the German turnover of one party exceeds EUR 25 million, while no other party to the transaction has German turnover of more than EUR 5 million; (3) the consideration for the transaction exceeds EUR 400 million; and (4) the target is active in Germany "to a considerable extent." Although the standard for "active to a considerable extent" is undefined, comments to the legislation note that an online messaging platform with one million active users in Germany would be "active to a considerable extent," whereas a Canadian conglomerate selling its automotive business with German turnover below EUR 1 million would not. These examples highlight the intended target of these changes – the messaging platform example is a direct reference to the *Facebook-WhatsApp* transaction that involved innovative, data-heavy markets, whereas the Canadian automotive example reflects a more mature, stable market that is not the intended target of the rules.

- In Austria, a similar SOT test took effect on November 1, 2017. This new threshold applies to transactions where (1) the parties' combined worldwide turnover exceeds EUR 300 million, (2) the parties' combined Austrian turnover exceeds EUR 15 million, (3) the transaction consideration exceeds EUR 200 million, and (4) the target has "significant activities" in Austria. While "significant activities" in Austria is not explicitly defined, the explanatory notes of the legislation provide some insight. The notes indicate that "significant activities" may be assumed if the target has a business location in Austria, which may be determined based on generally recognized metrics in the respective industry. For instance, in the digital sector, monthly active users or a website's unique visitor count may be used to assess significant activity. Similar to Germany's amended thresholds, Austria's SOT threshold will likely impact real estate deals involving newly developed real estate with insignificant turnover but with a transaction value exceeding the SOT threshold, pharmaceutical companies with no or insignificant turnover but holding valuable pipeline products, and start-up companies in the digital space, including media and technology businesses that have a large number of users or a significant presence in Austria but that do not derive significant turnover in that country.

- In China, MOFCOM recently announced that new merger control measures may be released and enacted in the next year. Among the changes, MOFCOM indicated that it aims to clarify its definition of "control" given the current ambiguity. Currently, Chinese regulations broadly construe control, capturing acquisitions of less than 50 percent of a target where the acquiring party receives certain veto or approval rights. The clarification on control, and whether MOFCOM may extend its merger notification regime to minority acquisitions, will be an important development to monitor. MOFCOM has also indicated that it expects the new measures to provide it with authority to investigate smaller transactions that fall below the turnover thresholds. Although the mechanics of such authority remain to be seen, MOFCOM is expected to release proposed revisions to the merger control measures later this year.

- In Mexico, recent developments now require private equity firms to disclose the limited partners of their funds that hold an economic stake of more than 5 percent. Despite raising significant concerns with disclosing such private and typically well-guarded confidential information, the Federal Economic Competition Commission ("COFECE"), the Mexican competition authority, mandates reporting such sensitive information due to the authority's concerns over gaining greater disclosure about the nature and identity of the reporting and investing entities.

Throughout the rest of the world, several new merger control regimes have been announced or enacted, many of which may affect transactions for private equity companies with a global presence. Several jurisdictions have announced the implementation of merger control regimes in the last year, including Chile, Vietnam, the Philippines, Nigeria, among others.

- Chile has implemented a mandatory regime that requires notification where parties have a combined Chilean turnover of UF1.8 million (approximately $70 million) and each party has individual Chilean turnover of UF290,000 (approximately $10 million).

- Vietnam has issued draft legislation that proposes mandatory notification where the total transaction value is VND300 billion (approximately $13 million) or greater, one party has greater than a 20 percent market share or one party has Vietnamese turnover of VND 500 billion (approximately $23 million) or greater.

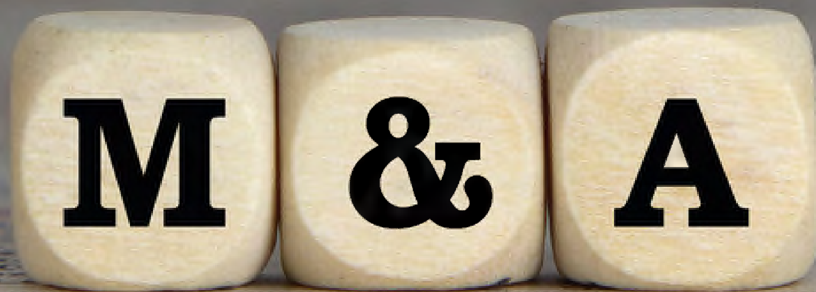
- The Philippines implemented a mandatory regime that requires notification where (1) the value of assets or aggregate annual gross revenues in, into or from the Philippines exceeds 1 billion Philippine pesos (approximately $21 million), (2) the transaction value exceeds 1 billion Philippine pesos (approximately $21 million), and (3) the acquiring entity will hold, as a result of the transaction, at least 35 percent of the voting securities of an issuer or have the right to at least 35 percent of the profits or, upon dissolution, assets of a non-corporate entity. In addition, despite initially requiring parties to file a merger notification pre-signing, recent changes to the regime now require a post-signing (but pre-closing) filing and the regime continues to undergo significant amendments.

- Nigeria has issued draft legislation that would create a new competition commission with authority to review mergers and mandate notification where the parties' combined turnover and assets are between 1 billion naira and 5 billion naira (approximately $3 million and $15 million).

IV. CONCLUSION

With such complex rules in key jurisdictions, including the increasing regulatory review of transactions in nascent regimes, private equity firms must implement a worldwide merger control strategy in order to obtain clearance for deals on a timely basis, even in the absence of substantive issues. Behind a wave of investment activity in the European market and the booming digital technology sector, additional rule changes seem inevitable. The amended thresholds in Germany and Austria exemplify the expanding scope of global merger control and private equity firms should expect to face potential filing obligations in a growing number of jurisdictions.

HSR AND ANTITRUST CONSIDERATIONS FOR PRIVATE EQUITY FIRMS IN M&A TRANSACTIONS



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I. INTRODUCTION

An increasing number of M&A transactions each year involve private equity firms. Like any other transaction, the parties in private equity deals must be cognizant of the filing requirements under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act") and the substantive requirements of the Clayton Act § 7, which prohibits transactions that may "substantially . . . lessen competition" or "tend to create a monopoly." Over the years, the HSR rules have been modified to target certain information specific to private equity firms and generally have been adding to the burden of the filing parties in private equity transactions. The requirements sometimes differ from those applicable to deals that do not involve private equity firms. This article discusses some of the HSR and antitrust issues that should be considered, and frequently arise, in private equity transactions.

II. DETERMINING THE REPORTABILITY OF A PRIVATE EQUITY TRANSACTION

Determining whether a private equity transaction requires the parties to prepare and file HSR forms, pay the required filing fee and observe the HSR waiting period prior to closing generally depends on whether the "size of transaction" and "size of person" tests are met. Private equity deals that may at first blush appear to be reportable are often determined not to be reportable after a thorough analysis.

In general, the size of transaction test is met if $80.8 million or more of assets, voting securities and/or non-corporate interests are being acquired. The size of transaction considerations are generally the same in private equity deals as they are in other deals.[2] Amounts used to pay transaction expenses and retention bonuses do not count toward the size of transaction thresholds. Similarly, repayment of debt does not count toward the size of transaction threshold (except in asset acquisitions). If a private equity firm is increasing its stake in an entity over time, it must remember to follow HSR aggregation rules and aggregate the current value of what has already been acquired with what will be acquired from the acquired person. Also, in the case of the acquisition of voting securities, there are three different filing thresholds and a new filing is required before a higher threshold can be exceeded. The amount of the filing fee differs depending upon the size of the transaction (at or in excess of $80.8 million, $161.5 million or $807.5 million).[3]

Even if the size of the transaction exceeds $80.8 million, a private equity deal can still be unreportable if the size of person test is not met. This test is based on the size of the acquiring and acquired persons. In general, the size of person test is met if one person has total assets or annual net sales of at least $16.2 million and the other person has total assets or annual net sales of $161.5 million or more, unless the value of the transaction is greater than $323 million, in which case the size of person test does not apply and the transaction is reportable.[4] For HSR purposes, a "person" refers to the Ultimate Parent Entity ("UPE"). A UPE is an entity that is not controlled by any other entity.

Private equity firms are typically structured as limited partnerships and are often their own UPEs because they are not controlled for HSR purposes by their limited partners or general partners.[5] The fact that a limited partnership is managed by a general partner is irrelevant to the HSR control analysis.

Accordingly, where the acquired person does not meet the larger size of person test, an acquiring fund may discover that the entire transaction fails the size of person test because it too, fails to meet the larger size of person test. Private equity firms should also be aware that a newly formed entity such as a new fund or a newly formed acquisition vehicle, which is its own UPE and does not have a regularly prepared balance sheet, may exclude from the "size-of-person" analysis the funds to be used for the acquisition, so long as the transaction value does not exceed $323 million. A fund that has only completed a few small acquisitions or investments may also fall into this category if it has no regularly prepared balance sheet.

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2 15 U.S.C. §18(a)(2)(B) (the $80.8 million threshold is for 2017). All HSR thresholds are adjusted annually and new thresholds go into effect each February.

3 These thresholds are for 2017.

4 15 U.S.C. §18(a)(2)(A) (the $16.2 million, $161.5 million and $323 million thresholds are for 2017).

5 For HSR purposes, "control" is different for corporations and unincorporated entities. Control of a corporation is defined as holding, directly or indirectly, 50 percent or more of the corporation's outstanding voting securities or having the contractual right to designate 50 percent or more of the board of directors. For unincorporated entities (i.e. limited liability companies and partnerships), "control" is defined as the right to receive 50 percent or more of the profits or 50 percent or more of the assets upon dissolution. 16 C.F.R. § 801.1(b).

III. INVESTMENT ONLY EXEMPTION FOR PASSIVE INVESTMENTS

Numerous and often complex exemptions to HSR reportability exist. If correctly applied, these exemptions can spare a private equity firm the time and expense of preparing an HSR filing and observing the waiting period. However, if incorrectly applied, or if circumstances change, a private equity firm can find itself facing a fine of over $40,000 per day for HSR noncompliance.[6] One common exemption that is relevant to private equity firms, which has generated some recent enforcement actions due to its misapplication, is the investment-only exemption for passive investments.

The HSR Act exempts acquisitions of up to ten percent of voting securities if they are made solely for investment purposes, regardless of the dollar value of voting securities acquired or held.[7] To qualify for this exemption, the acquirer must be a passive investor. Voting the stock will not eliminate the exemption, but getting involved in the business activities of the issuer will. This "investment-only" exemption has been interpreted narrowly, and alleged violations have been strictly pursued by the antitrust enforcement agencies in recent years.

The presence of any of the following factors can create a presumption that securities are not being held only for investment: "(1) nominating a candidate for the board of directors; (2) holding a board seat or being an officer; (3) proposing corporate action that requires shareholder approval; (4) soliciting proxies; (5) being a competitor of the issuer; or (6) doing any of the foregoing with respect to any entity directly or indirectly controlling the issuer."[8] Recent enforcement actions have shed additional light on these factors.

For instance, in 2015, the Federal Trade Commission ("FTC") entered into a settlement with three affiliated hedge fund companies and their management company, Third Point LLC, on charges that they violated the HSR premerger notification requirements by improperly relying on the "investment-only exemption" in connection with their 2011 acquisitions of stock in Yahoo! Inc. According to the complaint, "defendant Third Point LLC, which made investment decisions on behalf of the funds, took actions inconsistent with an investment-only intent, such as communicating with third parties to determine their interest in becoming the CEO or a board candidate of Yahoo." In addition, Third Point allegedly announced that it was prepared to propose an alternate slate for the board and assembled the alternate slate, sent a letter informing Yahoo that it was prepared to join the board, and internally discussed a possible proxy battle. Such actions will eliminate the investment-only exemption.[9]

More recently in 2016, the Department of Justice ("DOJ") announced that activist investor ValueAct Capital agreed to pay a record $11 million fine to settle allegations that it violated the notification requirements of the HSR Act. According to the DOJ complaint, ValueAct purchased shares of Halliburton and Baker Hughes after the two companies announced their merger, and while an antitrust review of the transaction was underway, with the intent to influence the companies' business decisions in connection with the merger and influence the outcome of the antitrust review. Specifically, the Complaint alleges that:

> ValueAct intended to use its position as a major shareholder of these companies to obtain access to management, to learn information about the merger and the companies' strategies in private conversations with senior executives, to influence those executives to improve the chances that the merger would be completed, and to influence other business decisions whether or not the merger went forward.[10]

As a result, it could not rely on the HSR "investment-only" exemption.

The antitrust agencies have made it clear that the intent of the investor is key to the applicability of the exemption. As a result, any private equity firm interested in relying on this exemption should consider whether its role might change from passive to active, and importantly, re-assess its intent upon each subsequent acquisition of additional shares of the same issuer. Likewise, additional acquisitions that bring a private equity firm's total holdings over 10 percent of the issuer's outstanding voting securities will eliminate the exemption.

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6 16 C.F.R. 1.98(a), 15 U.S.C. §18(a)(g)(1).

7 16 C.F.R. § 802.9.

8 See 43 Fed. Reg. 33,450, 33,465 (July 31, 1978); ABA Section of Antitrust Law, Premerger Notification Practice Manual, Interpretation 127 (5th Ed. 2015).

9 See: https://www.ftc.gov/news-events/press-releases/2015/08/third-point-funds-agree-settle-ftc-charges-they-violated-us.

10 See: https://www.justice.gov/opa/pr/justice-department-obtains-record-fine-and-injunctive-relief-against-activist-investor.

IV. UNDERSTANDING THE COMPETITIVE IMPACT OF THE PROPOSED TRANSACTION

There is sometimes a misconception that a private equity deal is not likely to generate any substantive antitrust concerns because it involves a financial buyer rather than a strategic buyer. While that may often be true, it is not always true, particularly where a private equity firm has already made prior acquisitions or investments in the same market segment. Indeed, the operations of their portfolio companies and those of their associates (explained in more detail below) will guide the competitive impact analysis of the antitrust agencies. Private equity firms should therefore remain cognizant of the potential competitive impact of any proposed acquisitions and analyze each of them carefully under the DOJ and FTC's 2010 Horizontal Merger Guidelines when designing and implementing their acquisition and disposition strategies.[11]

Recent transactions illustrate that antitrust agencies analyze the substantive antitrust issues facing M&A deals involving funds just as rigorously as in any other transaction. For example, hedge fund SPO Partners II, L.P. acquired Aggregates USA, LLC in 2010, but when it proposed to sell Aggregates USA to competitor Vulcan Materials Company in 2017, the DOJ and the State of Tennessee filed a complaint seeking to enjoin the proposed acquisition. According to the complaint, the two companies were the only producers of coarse aggregate in parts of Tennessee and Virginia, and their combination would result in higher prices and reduced service for customers in those areas. In December 2017, the DOJ required Aggregates USA to divest certain quarries and yards to resolve the department's competitive concerns.[12]

Similar results have occurred in other recent deals. In 2016, GTCR Fund X/A AIV LP and its subsidiary Cision US Inc. agreed to divest the public relations workflow software suites sold under the Agility and Agility Plus brands, as a condition of the acquisition of UBM's PR Newswire business, to prevent a duopoly in the provision of media contact databases to businesses and other organizations in the United States.[13] And in 2015, Cerberus, a private equity fund that was the majority owner of Albertsons, was required, along with Albertsons and Safeway Inc., to agree to sell 168 supermarkets to settle FTC charges that the proposed $9.2 billion merger of Safeway and Albertsons would likely be anticompetitive in 130 local markets in Arizona, California, Montana, Nevada, Oregon, Texas, Washington and Wyoming.[14]

As with any transaction, the substantive antitrust issues and risks depend on the specific facts relating to the market or markets affected by a proposed transaction.

V. PREPARING AN HSR FORM FOR A PRIVATE EQUITY FIRM

When a transaction involving a private equity firm is determined to be reportable and the HSR form must be prepared, there are certain unique issues that apply to HSR forms in private equity deals. These unique reporting considerations are the product of recent amendments to the rules and interpretations by the FTC. Over time, the antitrust agencies have been modifying their requirements in order to ensure that competitive issues that arise in private equity deals do not escape scrutiny, which has led to greater burdens on private equity firms.

For instance, Item 4(b) requires the submission of annual audited financials for the filing person and entity. The acquiring person must also submit unconsolidated financials for any controlled entity that generates revenue in a North American Industry Classification System ("NAICS") code from which the acquired person or entity also generates revenue. In other words, financials for entities contributing to horizontal overlaps must be provided. Prior to a September 1, 2016 amendment, a single consolidated financial statement covering the UPE and all controlled entities would have satisfied this requirement. This change was made because consolidated annual reports, particularly for funds, do not always provide sufficient information about the specific operating company that contributes to a horizontal overlap.[15]

Perhaps the biggest hurdle relating to the preparation of an HSR form in a private equity deal is the "associates" analysis and related reporting requirements that apply to acquiring persons. This was the product of a 2011 amendment. Item 6(c)(ii) of the HSR form requires an acquiring person to list minority holdings of its associates that contribute to a NAICS code overlap with the acquired person, and Item 7(b)(ii) requires an acquiring person to list operating companies controlled by its associates that contribute to a NAICS code overlap with the acquired person. The purpose of this addition was to close a gap in information regarding entities that are commonly managed with the acquiring person,

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11 See: https://www.justice.gov/atr/horizontal-merger-guidelines-08192010#1.

12 See: https://www.justice.gov/opa/pr/justice-department-requires-vulcan-divest-17-aggregate-facilities-order-acquire-aggregates.

13 See: https://www.justice.gov/opa/pr/gtcr-agrees-divest-third-largest-media-contact-database-provider-us-order-proceed-acquisition.

14 See: https://www.ftc.gov/news-events/press-releases/2015/01/ftc-requires-albertsons-safeway-sell-168-stores-condition-merger.

15 See: https://www.ftc.gov/enforcement/premerger-notification-program/informal-interpretations/1610008.

such as families of investment funds, but are not under common HSR "control." In order to provide this information, a private equity firm must first identify its associates.

16 CFR 801.1(d)(2) provides that an "associate" of an acquiring person is an entity that is not an affiliate of such person but: (a) has the right, directly or indirectly, to manage the operations or investment decisions of an acquiring entity (a "managing entity"); (b) has its operations or investment decisions, directly or indirectly, managed by the acquiring person; (c) directly or indirectly controls, is controlled by, or is under common control with a managing entity; or (d) directly or indirectly manages, is managed by, or is under common operational or investment management with a managing entity. The FTC offers numerous informal interpretations, as well as a 16-page "Decision Tree For Identifying Associates," to help identify associates.[16]

Examples of associated entities include the general partner of the UPE or other entities with the same general partner. As mentioned above, private equity funds are generally their own UPEs as they are not controlled for HSR purposes by their general partners. Thus, the associates analysis allows the antitrust agencies to see the bigger picture and capture information relating to general partners and entities under common management that may impact the substantive Clayton Act §7 analysis.

Accordingly, private equity firms should consider taking a thorough look across their family of funds to identify their associates up front. Once identified, it is a good idea to keep a list of such entities and their respective NAICS codes to facilitate future filings. Despite the guidance provided by FTC, the exercise remains difficult and time consuming, in particular for a first filing.

Where a private equity firm is the acquired person, it avoids these issues. Information relating to associates is only required for the acquiring person's form.

VI. CONCLUSION

In conclusion, conducting a thorough HSR and antitrust analysis in a private equity M&A deal can be a time-consuming and complicated exercise, particularly where a private equity firm is the acquiring person. Parties must remember that the information required for an acquiring private equity firm's form can be significantly greater than when that same firm is the acquired person. Sufficient lead time should be built in to permit investigation and analysis by outside counsel. Keeping updated records from transaction to transaction regarding information that may apply to future HSR filings can streamline the process and make things much easier when an HSR form must be prepared. Finally, like any other transaction, the substantive antitrust issues under Clayton Act §7 should be thoroughly analyzed.

16 Decision Tree For Identifying Associates, available at: https://www.ftc.gov/sites/default/files/attachments/hsr-resources/decision-tree.pdf; ABA Section of Antitrust Law, Premerger Notification Practice Manual, Interpretation 204 (5th Ed. 2015); FTC Informal Interpretation No. 1607005, available at: https://www.ftc.gov/enforcement/premerger-notification-program/informal-interpretations/1607005; FTC Informal Interpretation No. 1109003, available at: https://www.ftc.gov/enforcement/premerger-notification-program/informal-interpretations/1109003; FTC Informal Interpretation No. 16110001, available at: https://www.ftc.gov/enforcement/premerger-notification-program/informal-interpretations/16110001.

PRIVATE EQUITY BUYOUTS: ANTI- OR PRO-COMPETITIVE?

Buyout

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I. INTRODUCTION

Private equity firms ("PE firms") have become common owners of established firms in concentrated markets. PE as an asset class consists of around 4,000 funds with assets under management of more than $2.45 trillion, of which buyout funds account for 60 percent.[2] According to Invest Europe, European private equity and venture capital funds raised around €240bn during the years 2012-2016. The total sum invested in European companies by private equity in 2016 was about €52.5 billion, of which buyout investment amounted to €36.5 billion into over 1,000 companies.

Antitrust authorities therefore intervene in mergers and acquisitions involving PE firms. For example, in October 2011 a federal judge in the U.S. stopped H&R Block from acquiring 2nd Story Software, owned by the PE firm TA Associates. The Justice Department argued that the merger would harm competition in the market for digital tax preparation services, which was dominated by only three players (H&R Block, 2nd Story Software and Intuit). There has also been a class action law suit accusing seven PE groups — KKR, Blackstone, TPG, Bain Capital, Goldman Sachs, Silver Lake Partners and Carlyle — of conspiring to fix prices in some of the world's biggest leveraged buyouts. In November 2014, Judge Young approved settlements related to the class action, which claimed these PE firms teamed up to keep leveraged buyout prices low.

PE firms have also come under the scrutiny of competition lawyers in the European Union. In April 2014 the European Commission found that 11 producers of underground and submarine high voltage power cables operated a cartel, and imposed fines totaling €302 million. The EC found Goldman Sachs' PE unit to be "jointly and severally liable" with its portfolio company Prysmian. Goldman Sachs was fined €37 million. PE firms have also been fined in the EU Member States. In November 2014, the Dutch regulator ACM imposed fines on a number of firms engaged in cartel conduct in the flour industry. The ACM fined three PE firms €1.9 million for exercising decisive influence over one of their portfolio companies, Meneba, a Dutch flour producer, which was involved in the cartel.

Thus, even though PE firms are not "traditional" parent companies, they can be held responsible for the actions of their portfolio companies if regulators believe that they exercise decisive influence or control over the portfolio company.

In this article, we discuss the antitrust implications of an active PE market and whether there are any special characteristics of PE ownership that are important for antitrust regulation and enforcement. To gain some perspective, we approach the question from three pillars of industrial organization: (i) identifying and blocking mergers that create substantial market power; (ii) detecting and preventing predatory behavior; and (iii) detecting and preventing collusive behavior.

II. MERGER CONTROL

Blocking mergers that hurt consumers is a central part of antitrust regulation in most jurisdictions. PE firms are temporary owners of assets and therefore routinely involved in buying and selling companies. PE ownership is temporary because the funds they raise are structured as limited partnerships with a preset contractual life. Before the fund expires, PE firms have to sell the businesses they acquired with money raised by the fund. PE funds typically run from 10 to 12 years, but the median holding period of a portfolio company is only six years.

Temporary ownership by private equity in concentrated markets can affect incentives to invest in restructuring and reorganizing firms. As we have shown in previous research,[3] the fact that the private equity owner will eventually sell the target firm to incumbents increases incentives to restructure the target firm. To see why, first note that an incumbent's valuation of the target takes account of the incumbent's profits when owning the target relative to profits when a rival possesses it. A more efficient — restructured — target firm is therefore not only more valuable to an incumbent thanks to the bigger profit stream: the higher value also stems from the threat that a more efficient target will end up in a rival's hands. When PE firms restructure target firms with the intention to sell them to incumbents, they internalize how the acquisition price is affected by the "carrot" (higher profit as acquirer), as well as the "stick" (lower profit as non-acquirer).

2 McKinsey & Company, "A Routinely Exceptional Year: McKinsey Global Private Markets Review," (2017).

3 Norbäck, Persson, & Tåg "Buying to Sell: Private Equity Buyouts and Industrial Restructuring" CESifo Working Paper Series no. 4338 (2013), Available at SSRN: https://ssrn.com/abstract=2302493.

Thus, temporary ownership by PE firms in concentrated markets should be associated with more restructuring in terms of decreased marginal costs, increased product quality or more product variety. Indeed, there is ample empirical evidence that PE firms raise the productivity of the businesses they acquire.[45] This more aggressive restructuring likely benefits consumers through lower prices and higher quality products.

Temporary ownership by PE firms can also indirectly assist antitrust authorities with merger control, because an active PE market can trigger mergers between incumbents in a merger-stable industry. Consumer surplus-enhancing or welfare-enhancing mergers in an oligopoly may not be privately profitable, which presents antitrust authorities with a problem since they cannot force firms to merge. Our research demonstrates that introducing PE firms as potential acquirers changes the bidding behavior of incumbents.[6] They now have incentives to outbid PE firms to prevent aggressive reorganization of their rivals. In fact, the mere threat of a PE acquisition — followed by aggressive restructuring to extract a high exit price — acts as a trigger for previously privately unprofitable mergers. If an antitrust authority can prevent mergers that reduce consumer surplus, all mergers triggered by an active PE market are beneficial for consumers.

Finally, an active PE market can also benefit consumers by preventing concentration in an industry. An antitrust authority may want to block an incumbent acquisition because of concerns about increasing concentration. However, blocking acquisitions may come at the cost of forgoing the reorganization of inefficient firms. In the presence of an active PE market, however, by blocking trade sales as an exit route, the antitrust authority can instead allow a PE acquisition and ensure that the exit leads to an IPO, rather than a sale to an incumbent rival. Thus, the antitrust authority can "have the cake" (reorganization) and "eat it too" (retain product market competition). This effect can be of particular importance in developing countries where cross-border PE can serve as restructuring expertise which prepares targets for IPOs or subsequent cross-border M&As.[7]

Some recent empirical research suggests that PE ownership is associated with more aggressive investments and pricing. For instance, Fracassi et al[8] show that consumers could gain from PE ownership since product market prices remain about constant while product variety increases. There is also some evidence that quality-adjusted prices fall following PE takeovers in the restaurant industry.[9]

III. PREDATORY BEHAVIOR

A second concern of antitrust authorities is that a dominant firm can suppress competition in the market by predatory or entry-deterring behavior. There are several economic models showing how a dominant firm can behave in a predatory fashion to enhance its profit in a way that is detrimental to welfare. A crucial prerequisite for predation to be rational is that an incumbent (or predator) has an initial advantage.[10] Such initial advantages for the incumbent may come from an existing customer base, key infrastructure or deep pockets.

Here, the special financial structure of PE firms and their deep-pocket nature may come into play. In fact, this may make PE owned firms both more likely to behave in a predatory way, and to be exposed to predatory behavior.

On the one hand, PE firms have access to resources from the funds they have raised from investors, and they also have good connections to banks and are well versed in raising private debt financing. Indeed, relaxing the financial constraints on targets is a key element of value creation and growth in PE buyouts. As theories of deep pocket predation suggest, this may make PE-backed firms more able to prey on financially weaker rivals, as better relations with financiers might equip them with the necessary endurance to win predatory price wars.On the other hand, the target firms they acquire are typically heavily leveraged. The target firms' high leverage makes PE firms less well equipped to take losses

4 Davis, Haltiwanger, Handley, Jarmin, Lerner & Miranda, "Private equity, jobs, and productivity," *American Economic Review* 104, (2014): 3956–90.

5 Olsson & Tåg, "Private Equity, Layoffs, and Job Polarization," *Journal of Labor Economics* 35, (2017): 697–754.

6 Norbäck, Persson & Tåg, Threatening to Buy: Private Equity Buyouts and Antitrust Policy (December 18, 2017). Economics Letters, Forthcoming. Available at: https://ssrn.com/abstract=3089957.

7 Baziki, Norbäck, Persson & Tåg, "Cross-Border Acquisitions and Restructuring: Multinational Enterprises versus Private Equity-Firms," *European Economic Review* 94, (2017): 166–184.

8 Fracassi, Previtero & Sheen, "Is Private Equity Good for Consumers?" Kelley School of Business Research Paper no. 17-12 (2017), Available at: https://ssrn.com/abstract=2302493.

9 Bernstein & Sheen, "The operational consequences of private equity buyouts: Evidence from the restaurant industry," *The Review of Financial studies 29*, no. 9 (2016): 2387-2418.

10 Fumagalli, Motta & Calcagno, Exclusionary Practices: *The Economics of Monopolisation and Abuse of Dominance*, Cambridge University Press, (2017).

resulting from predatory behavior of rivals. Indeed, competition following buyouts intensifies when rivals are less leveraged.[11] This suggests that financially strong rivals can afford to prey on highly leveraged buyout targets.

There are also reasons to expect less predatory behavior from PE-backed firms. PE firms are good at aligning incentives for managers to reduce agency costs in companies. If the previous management had empire-building tendencies, they might have kept prices artificially low or applied predatory practices to maximize market share rather than profits. PE ownership in such a situation may mean that such credible non-rational predatory behavior becomes non-viable, and thus the likelihood of predatory behavior decreases.

In sum, when it comes to predatory behavior, specific circumstances seem to be an important determinant of which mechanism will dominate. PE ownership can either encourage or discourage predatory behavior.

IV. COLLUSION

A third concern motivating antitrust law is that firms may collude to raise prices or protect their markets. Are PE firms more inclined to behave collusively than more permanent owners of assets?

Here the temporary ownership of PE again comes into play, for at least three reasons. First, if the market is collusive, then bidding competition is weak between incumbents for targets up for sale. As we described above, temporary owners will overinvest in order to maximize the exit price. To achieve a high exit price, however, a PE firm needs to have bidding competition. Collusion in the market will generally not facilitate such competition.[12]

Second, aggressive restructuring by a PE firm due to temporary ownership may create highly asymmetric market structures with some rivals becoming fairly small *ex-post*. Research has shown that relatively small firms have low incentives to stay in a cartel. Including an indivisible cost of cartelization, medium asymmetric market structures can be then more conducive to collusion, since they balance the small firms' incentives to stay in the cartel against the need to cover the cartel leaders' indivisible cartelization cost. Thus, unless the PE firm becomes a cartel leader, the risk of collusion seems likely to decrease under PE ownership.[13]

Third, temporary ownership means that PE firms will optimize over a different time horizon compared to more permanent owners. Obara and Zincenko[14] examine the impact of heterogeneous discounting rates on collusion and show that average discount rates need to be above a certain threshold for collusive behavior to be sustainable. One might suspect that a PE acquisition would reduce the average discount rate due to ownership being temporary, and thus reduce the likelihood of collusive agreements, but a formal analysis seems necessary before drawing any stronger conclusions.

Moreover, in addition to collusion in the product market, another important aspect is potential collusion within the PE industry itself when bidding for target firms. Collusion theory suggests that frequent and long-running interactions might support collusion; cooperation among PE firms might therefore spill over into illegal cooperation. Joint bidding might be motivated on efficiency grounds, but also by limiting the bidding competition for firms. There is no clear evidence of anti-competitive bidding by PE firms: bidding contests in which PE consortiums are involved seem not to have systematically lowered takeover competition or target returns.[15]

Finally, it is worthwhile noting that common ownership of firms, as is the case when a PE firm manages several firms in the same fund or across funds, may reduce competitive pressure even absent tacit or formal collusion since incentives to compete may be reduced.[16]

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11 Chevalier, "Do LBO supermarkets charge more? An empirical analysis of the effects of LBOs on supermarket pricing," *The Journal of Finance 50*, no. 4 (1995): 1095-1112.

12 Norbäck & Persson, "Entrepreneurial Innovations, Competition and Competition Policy," *European Economic Review* 56, no. 3 (2012): 488-506.

13 Ganslandt, Persson & Vasconcelos, "Endogenous Mergers and Collusion in Asymmetric Market Structures," Economica, 79 (2012): 766–791

14 Obara & Zincenko. "Collusion and Heterogeneity of Firms," *The RAND Journal of Economics 48*, no 1. (2017): 230-249.

15 Boone & Mulherin, "Do private equity consortiums facilitate collusion in takeover bidding?" *Journal of Corporate Finance 17*, no. 5 (2011): 1475-1495.

16 Azar, Schmalz & Tecu, "Anti-Competitive Effects of Common Ownership," *The Journal of Finance*, (2018), Forthcoming.

V. CONCLUSIONS

The literature on the impact of private equity ownership on antitrust policy is still in its infancy and more research is needed. However, existing studies support some initial insights of relevance to policy.

If antitrust enforcement is working efficiently, PE ownership should be pro-competitive, since diversity among bidders expands the choices facing antitrust authorities in the enforcement of merger control. In particular, as argued above, temporary ownership by PE firms in concentrated markets should be associated with more restructuring, leading to decreased marginal costs, increased product quality or more product variety. This is likely to benefit consumers.

In areas where antitrust enforcement is more difficult and costly, private equity ownership needs to be more carefully assessed. Concerning the risk of collusion in the product market, it seems likely that PE ownership is not a serious concern. Private equity ownership seems likely to create asymmetries in the product market regarding production costs and time horizons, making collusion harder to sustain. However, collusion within the PE industry itself when bidding for target firms seems more of a concern. Regarding the effects of PE ownership on predatory behavior, different mechanisms point in different directions, suggesting that specific market conditions must be taken into account.

Finally, we think that the existing research on private equity and antitrust clearly suggests that more attention should be devoted to understanding how different forms of corporate ownership affect antitrust policy.

PREMERGER CONTROL OF PRIVATE EQUITY FUNDS: THE BRAZILIAN PERSPECTIVE

BY JÚLIA BATISTELLA-MACHADO & BRUNO RENZETTI[1]

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I. INTRODUCTION

As the Brazilian economy slowly regains traction, the country also returns to the whitelist of national and international private equity funds ("PE Funds"). In 2016-2017 alone, dozens of PE Funds — mostly from Brazil and the United States, but also from the United Arab Emirates, the United Kingdom, China and others — reported altogether more than 160 transactions with Brazilian companies as targets.

PE funds' strategies are sometimes based on market consolidation, i.e. the acquisition of companies in the same industry to gain certain competitive advantages. In view of that, one may ask whether the Administrative Council for Economic Defense ("CADE"), the Brazilian authority for antitrust related issues, find reasons for deeper scrutiny of private equity funds, and, if so, how is such analysis performed.

In this paper, we aim at answering the main questions related to the premerger control of private equity funds in Brazil. We begin by introducing the premerger control, in view of the changes in the competition policy in the last five years. We then explain whether CADE requires premerger approval for PE funds, the criteria, the timing, the information required, the analysis undertaken by the authority and the consequences of not notifying in due time. We end the paper with a summary and our conclusions.

II. PREMERGER CONTROL

Brazil adopted "*prior* premerger" control in 2011-2012. As redundant as it may sound, until then, notifications of mergers and acquisitions were typically done *after* the closing, and CADE could later decide to reverse it or to inflict restrictions to the transaction. Such administrative proceedings could last for several months or even years.

Things are remarkably better now. CADE has undergone relevant changes in its structure and legal mandate, and mergers and acquisitions which are subject to scrutiny must be *previously* cleared by CADE. Most notifications (97 percent) are nowadays decided at the first instance by the General Superintendence, instead of at the second instance by the Administrative Tribunal. This reorganization also resulted in the average duration of the administrative proceeding reduced from more than 150 days to less than 30 days.

The new scenario caused the number of notifications to decline from around 700 a year before 2012 to around 400 a year after it. This was due to clearer submission criteria. Before the law enacted in 2011, mandatory notification was triggered if a certain percentage of market share was reached, offering space to different interpretations with respect both to the definition of the market and the measurement of the market share. The law now requires transactions to be submitted only if the groups involved pass the Gross Revenue Test. There are additional rules applicable to investment funds and to minority stakes, which we explain further below.

We must say, however, that the rejection or any type of restrictions over transactions are still very limited considering the overall number of notifications (only 2.4 percent) — although very high among the cases challenged in the Administrative Tribunal (88.8 percent).

III. IS PREMERGER APPROVAL FROM TRANSACTIONS INVOLVING PRIVATE EQUITY FUNDS REQUIRED?

Perhaps to the surprise of some, it was only recently that CADE formed the understanding that transactions involving private equity funds should be subjected to premerger approval. As recent as 2012, for example, the authority spent more than 90 percent of a decision's length with considerations on whether the submission was required or not.

Indeed, under the ambiguity of the previous law, some methodologies have arisen by way of precedents to establish which investment funds' submissions could be waived. In a decision from 2002, the Administrative Tribunal recommended that premerger notification was not needed when done for the sole purpose of investment and pursuant to the ordinary business of the fund, provided that there was no influence over the commercial strategy of the company or, if so, it be solely to prepare the company for the partial or total sale, and as long that such control does not last more than a year. In another precedent from 2010, two additional criteria were included: the submission could be waived if investors did not have enough power to affect fund managers and the fund manager did not have enough influence over the target company.

A similar exemption was included in the bill of law of the current Brazilian Competition Act, dismissing the premerger control of temporary transactions with the purpose of resale, which lacked capacity to determine or to influence the competitive behavior of the target company or funds which only used political powers to prepare its resale.

However, not only this exemption was excluded from the last version of the bill. CADE later came to acknowledge that private equity funds were indeed subject to premerger control – provided that the following criteria were met.

IV. IN WHICH CASES MUST PRIVATE EQUITY FUNDS SUBMIT PREMERGER NOTIFICATIONS?

There are currently three tests to establish whether a private equity transaction must be submitted to CADE's approval: (1) the Gross Revenue Test, which depends on the definition of economic group and of the economic group of investment funds, and (2) the Equity Test or (3) the Convertible Bond Test.

- The Gross Revenue Test establishes that a transaction should only be notified if (a) one of the economic groups involved had higher turnover in Brazil than R$ 750,000,000.00 (roughly U.S. $230,000,000.00) in the last year, and (b) another economic group involved had higher turnover in Brazil than R$ 75,000,000.00 (roughly U.S. $23,000,000.00).

  The definition of economic group for the Gross Revenue Test include (a) all companies under common control, as well as (b) all companies where companies under common control hold at least 20 percent of the share capital or voting capital.

  In the context of investment funds, the definition of economic group considers (a) the economic group of each quotaholder holding 50 percent or more of the fund, individually or by any contractual means, (b) the targets controller by the fund or where the fund holds at least 20 percent of the share capital or voting capital.[2]

- The Equity Test establishes that the transaction should only be notified if (a) they result in the acquisition of individual or shared control of the target; or (b) in the event the target company is not a competitor nor has activities in the same supply chain: (b1) the buyer directly or indirectly acquires 20 percent or more of the share capital or voting capital; or (b2) at each additional acquisition of 20 percent or more of the share capital or voting capital; or (c) in the event the target company is a competitor or has activities in the same supply chain: (c1) the buyer directly or indirectly acquires 5 percent or more of the share capital or voting capital; or (c2) at each additional acquisition of 5 percent or more of the share capital or voting capital.

- The Convertible Bond Test establishes that any transaction based on bonds convertible in equity should be notified if (a) the convertible rights meet the levels set forth in the Equity Test, and (b) the buyer has the contractual right to nominate managers or supervisors, or has veto rights to competitive issues.

V. WHEN SHOULD PRIVATE EQUITY FUNDS REQUEST ANTITRUST APPROVAL?

Once identified that a transaction is subject to premerger filing, under the criteria set forth in the previous section, then the parties involved must submit the notification to CADE before any post-merger integration.

It has been questioned whether the investment agreement signed by the quotaholders could already be considered an associative agreement, requiring proper notification, since it is an agreement which establishes the share of risks and results between the parties, and the quotaholders may be competitors in the same relevant agreement. Although CADE has not issued an opinion on this matter yet, we understand that a specific antitrust approval should not be required for the fund's investment agreement because of the lack of economic activity of the fund, which will only provide such economic activity by means of the acquisition of target companies.

2 Before 2014, the definition of the economic group of the investment fund included all funds under the same management, the fund management itself, all quotaholders with 20 percent or more of any investment funds under the same management and all portfolio companies of each fund under the same management. In October, 2014, the references to the fund manager were excluded and the economic group limited to the fund directly participating in the transaction.

VI. WHAT INFORMATION WILL THE BRAZILIAN ANTITRUST AUTHORITIES REQUIRE?

Transactions considered simple – such as joint-ventures, the substitution of an economic agent, low market shares in the same geographic areas or in the same supply chain, HHI lower than 200 (if market share is lower than 50 percent), and other cases which are considered simple by the General Superintendence – can be notified under the summary procedure. In 2016, 80 percent of the notified transactions were considered simple.

If the General Superintendence considers a transaction as complex, it must be notified under the ordinary procedure. In both procedures, the parties will be required to deliver information and documents about the transaction, the history of transactions, the parties involved in the transaction and their economic groups. All documents related to the transaction, either in their final form or in their most recent versions, must have copies delivered to CADE, as well as any other agreements which may affect the political powers of the parties in the transaction.

It is worth noting that the definition of the economic group of the investment fund for the purpose of disclosure is different (and much wider) than the one established in the Gross Revenue Test. Here, the economic group must include (a) the fund involved in the transaction, (b) the funds under the same management (if related to the transaction relevant market), (c) the fund manager, (d) the economic group of the quotaholders directly or indirectly holding 20 percent or more of the fund involved in the transaction, (e) target companies controlled by or whether the fund involved in the transaction holds 20 percent or more of the share capital or voting capital; and (f) target companies controlled by or whether the fund under the same management holds 20 percent or more of the share capital or voting capital (if related to the transaction's relevant market).

Furthermore, all participation equal or higher than 10 percent in the share capital or voting capital of a company in markets related to the transaction, by any part of the economic group, shall also be disclosed to CADE, including the corporate structure chart.

Additionally, in the ordinary procedure, the parties will be required to describe other competitive aspects, such as the relevant market, by the supply side and the demand side, alternatives to sell, entrance and rivalry conditions and coordination.

Misleading or false information, document or statement will subject the responsible party to fines of up to R$ 5,000,000.00 (around U.S. $1,533,000.00) and to a new premerger control of the transaction, if applicable.

VII. HOW IS THE ANALYSIS OF ANTITRUST ISSUES UNDERTAKEN?

During 2016-2017, CADE reviewed a few mergers and acquisitions concerning investment funds, and all of them were approved without restrictions. The main defense accepted by the General Superintendence was that the targets held insignificant parcels of market share or that there was no overlapping with other companies of the same group, considering in particular the geographic area.

In the Concentration Act n. 08700.007133/2017-88, acquiring party Terraverde SA, controlled by a Brazilian Private Equity fund, sought to buy a stake of 32,1 percent of Lavoro Agrocomercial Ltda, a company active in the markets of seeds, pesticides and fertilizers.

During its analysis, the main issue raised by CADE was a possible vertical integration in the fertilizer market between Lavoro and an undisclosed company controlled by the same private equity fund. Nonetheless, CADE accepted the parties defense, which stated that both the undisclosed company and Lavoro had its own distributions networks and a reduced market share, setting aside any concerns regarding vertical integration. The merger was approved with no restrictions[3].

CADE also faced issues regarding investment funds in the Concentration Act n. 08700.007007/2017-23. In this matter, FIP Pirineus, a privately managed fund owned by the Tradener Group, and highly active in the renewable energy market, intended to buy 67,5 percent of the voting shares in Rondinha Energética S/A, operator of a small dam in Southern Brazil. The targeted shares were owned by Atlantic S/A and the merger would result in the exit of Atlantic.

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3 Additionally, the General Superintendence understood that the market shares were much too small to impact competition directly. The numbers are not publicly disclosed, but according to the analysis made by the Superintendence, even an eventual vertical integration would not be able to close the relevant market for competitors.

The merger was analyzed through the lens of two relevant markets: energy generation and energy trading. After collecting and evaluating data both from the regional and national market, CADE's opinion was that the merger would not affect competition neither in horizontal nor vertical markets, due to the low market shares of the parties. The merger was also approved without restrictions.[4]

Another operation that was approved by CADE with no restrictions was between Archy, LLC and Actis ED. Archy is a holding company, fully owned by GIC Ventures, and Actis ED is an investment fund owned and managed by several Latin-American funds, having investments in distinct economic sectors in Brazil. The proposed merger consisted in the acquisition by Archy, directly or indirectly through one of its subsidiaries, of the shares owned by Actis in Cruzeiro do Sul Educacional S/A, which has activities in the basic and higher education market.

The most important point in this case is that CADE acknowledged that there could be horizontal issues regarding the merger, but did not evaluate the merits of the concentration act, because CADE understood that the companies had businesses in different relevant markets.

We have not observed different analysis with regard to private equity, other than to the elements described in this paper – such as the definition of the economic group of investment funds. Overall, as mentioned, CADE is still renitent to inflict restrictions, and the large majority of transactions submitted are timely approved.

Additionally, since the establishment of the premerger control in 2012, CADE has enforced the necessity of timely notification before any closing or post-merger integration acts. Pursuant to article 88, section 3, of Law 12,529/2011, parties that fail to notify CADE in due time are subject to gun jumping fines of up to R$ 60,000,000.00 – roughly U.S. $18,000,000.00.[5]

VIII. CONCLUSION

In this short Q&A paper, we intended to provide the reader with an objective view of the premerger control in Brazil of transactions involving private equity funds. As we have noted, CADE has been historically more concerned with establishing tests and procedures on when and how to submit premerger fillings, than to perform deeper analysis on competitive consequences of said transactions. This may explain the low level of rejections and restrictions imposed by the authority in this context so far.

Even though, the applicable transactions must be notified to CADE in the due time. No closing and no post-merger integration may occur before the decision of the authority, otherwise the parties can be subject to high penalties. We have named the criteria which determine whether a transaction must be submitted or not as the Gross Revenue Test, the Equity Test and the Convertible Bond Test.

On the bright side for market players, premerger fillings are mostly done under the summary procedure, with simplified the amount of data and documents to be provided. Organization changes undergone by CADE in the last five years have also remarkably reduced the duration of the administrative proceeding, which in most cases is not greater than 30 days.

4 It must be borne in mind that the energy sector in Brazil has undergone unprecedented changes since the 1990s. Besides energy generation and energy trading, transmission and distribution are also very important relevant markets, even though they did not play a role in this specific case. Competition matters regarding regulated sectors usually raise various sorts of concerns, especially relating to relevant markets when analyzing a merger.

5 In order to explain and to solve questions regarding gun jumping, CADE published its "Guide for Premerger Analysis" in 2015, which can be found in its official website.

II. SELECTED ARTICLES FROM CRESSE 2017

ADVERTISING AND RELATED RESTRAINTS

BY JOHN ASKER & HESKI BAR-ISAAC[1]

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I. INTRODUCTION

A central feature of ecommerce is the ease with which consumers, manufacturers and retailers can obtain price and other information. Indeed, in its report on ecommerce, the European Commission notes "The results of the sector inquiry show that the increased price transparency online is the feature that most affects the behavior of customers and retailers."[2] In this context, it is perhaps unsurprising that the ecommerce sector is observing substantial and perhaps growing use of vertical restraints that are likely to be interfering with such price transparency to the benefit of firms. Whether these constraints are always to the benefit of consumers and competition is less clear.

This article describes those restraints, observed in ecommerce markets, which may be less familiar than other, better-studied in brick-and-mortar markets, vertical restraints, such as resale price maintenance, exclusive dealing arrangements and quantity forcing.[3] A prominent example of a common ecommerce-related restraint is a minimum advertising price ("MAP") restriction — a restraint whereby a manufacturer limits the price at which a retailer can advertise goods, while placing no restriction on the price actually charged. In an ecommerce context, a price published on the internet constitutes an advertised price, while the price revealed when presenting the shopping basket at checkout may be unconstrained.[4] Since these restraints can make it more difficult for consumers to know what price they will actually end up paying if they make a purchase at a particular retailer, they might work to counteract the price transparency for which ecommerce allows.

This article describes the economic and strategic logic underpinning the obfuscation of price information by manufacturers and retailers. The article explains why this logic may be quite different from that associated with more familiar price restraints. This finding is particularly noteworthy in light of recent decisions and statements of the UK's Competition and Markets Authority ("CMA") that suggest an equivalence between MAP restrictions and resale price maintenance ("RPM").[5]

II. ADVERTISING AND OTHER INFORMATION RESTRAINTS

In addition to highlighting the central role of price transparency, the European Commission report on the Ecommerce Sector Inquiry details a survey of more than a thousand retailers across the European Union. The survey notes that 8 percent of respondents mention limitations to online advertising. The most common restrictions reported are limitations, or recommendations, on price (reported by more than 42 percent of respondents). This broad characterization would appear to cover MAP-style provisions, among others.

While this EU report does not mention MAP restrictions explicitly, other evidence is suggestive of their prominence. Indeed, a simple internet search suggests that there is a competitive industry of firms that track and monitor violations of such policies.[6] Furthermore, it is easy to find many examples of MAP provisions in standard form distribution contracts posted by manufacturers online.[7]

The EU report also mentions several other restrictions that might make it more difficult for consumers to easily observe prices: 18 percent of respondents report that manufacturers limit their ability to sell through online marketplaces/platforms, 11 percent report being restricted to selling online only through their own websites, and 9 percent face limitations on the use of price comparison tools. Furthermore, the commission notes that "Some agreements between manufacturers and retailers therefore contain contractual restrictions under which the retailers are

2 European Commission, *Final Report on the Ecommerce Sector Inquiry*, May 2017, staff working document paragraph 147.

3 An excellent overview can be found, for example, in Rey & Vergé, "Economics of Vertical Restraints," in Handbook of Antitrust Economics, Buccirossi (ed.), The MIT Press, chapter 9, April 2008, pp. 353–390.

4 There is contractual variation in the nature of advertisements allowed. In a contract for Enerpac, a manufacturer of high-pressure tools and equipment, it is explicitly stated that an advertising "price too low to print" would comply with the contract. By contrast, Ergotron Inc, a technology furniture manufacturer, in its Unilateral Minimum Advertised Price Policy for its products that are sold in the United States and Canada, effective October 30, 2013, states that "As part of its online advertising, a Reseller may not express statements or other indications on its website in connection with any UMAP Product that indicates or implies that a lower price, inconsistent with the UMAP Policy, may be found at the online checkout stage, including but not limited to phrases such as: 'click here for a lower price'; 'add to cart for lower price'; and 'check cart for lower price.'"

5 In particular, see *Online resale price maintenance in the commercial refrigeration sector* Case CE/9856-14, May 24, 2016 and the discussion below.

6 Israeli, Anderson & Coughlan (2016), "Minimum Advertised Pricing: Patterns of Violation in Competitive Retail Markets," Marketing Science, 35(4), 539-564 uses data from one such firm and reports that "These policies are very common in many industries, including electronics (e.g. Sony, Bose, Samsung), cameras (e.g. Olympus), video games (e.g. Nintendo), housewares (e.g. Viking, Sub-Zero), sporting goods (e.g. Callaway, TaylorMade), computers (e.g. Hewlett-Packard), toys (e.g. Activision Blizzard, LeapFrog), marine equipment (e.g. JL Marine), motor sports (e.g. GPR Stabilizer), and plumbing (e.g. Brasstech).

7 A collection of such contracts is available at: www.johnasker.com/MAP.zip.

limited in their ability to actively provide information or otherwise promote their online product offering with price comparison tools." (European Commission, *Final Report on the Ecommerce Sector Inquiry*, staff working document paragraph 518).

III. A THEORETICAL EQUIVALENCE BETWEEN RPM AND MAP OR OTHER ADVERTISING RESTRICTIONS?

At first glance, it may seem that a minimum resale price maintenance provision and a minimum advertised price provision are much the same.[8] Indeed, recent decisions of the CMA, referenced above, are consistent with this view. Under some conditions, MAP and RPM may well be functionally equivalent. In what follows, these (somewhat restrictive) conditions are discussed.

In the absence of some impediments or "frictions" in consumers' ability to gather price information, all consumers should find the lowest price available. Competing retailers would, therefore, quickly end up charging the same price, absent differences in perceived service quality. However, evidence suggests that in online settings, price dispersion remains "sizeable, pervasive, and persistent."[9]

Hence, even in an online environment, it may not be trivial for consumers to find the good that best matches their preferences or the lowest price for a good that they wish to purchase. Indeed, concern over searches and the way that they have been manipulated led the European Commission to fine Google for abusing its market dominance as a search engine by giving an illegal advantage to its comparison shopping service. In the factsheet that accompanied the press release announcing this decision on June 27, 2017, the commission noted that "in the ten highest-ranking generic search results on page 1 together generally receive approximately 95% of all clicks on generic search results (with the top search result receiving about 35% of all the clicks). The first result on page 2 of Google's search results receives only about 1% of all clicks. The effects on mobile devices are even more pronounced given the much smaller screen size"[10]

Clearly, advertising restrictions, marketplace restrictions and limitations on price comparison tools do little to make it easier for consumers to gather price and other relevant product information.

In a seminal contribution by Peter Diamond, cited by the Nobel Prize committee in 2010 in announcing the award to Professor Diamond, it is shown that search frictions can have dramatic effects on prices.[11] The logic of this celebrated contribution, known as the Diamond paradox, is quite simple. Consider a market with many identical retailers selling the same good, and many identical consumers who are known to value the good at, for purposes of illustration, 10. Consumers have to visit a retailer to learn what price it charges, and doing so comes at a cost (albeit a small one, such as clicking on a few links and spending the time to read the site). This cost is identical for all consumers. Suppose it is 0.02. In this environment, even though there are many firms, the market equilibrium that emerges has all firms charging a price of 10 — the full consumer willingness to pay. This can be understood by supposing that it is not the case; that is, some other price is charged by firms. Next, given that in an equilibrium, consumers should correctly anticipate the distribution of prices across firms, a firm with the lowest price could raise this price by 0.01 (as long as the price is not higher than 10) and still expect the consumer to purchase there, since no consumer would pay 0.02 to visit another firm. Hence, for any price below 10, every firm has an incentive to increase its price by something less than 0.02, as this will have no impact on demand and will increase revenue and profit.

With this context, we can turn to alternative vertical restrictions and highlight an environment (albeit a somewhat special one) where there can be an equivalence between (minimum) RPM and restrictions that create search frictions (as limits on the use of price comparison sites, marketplace restrictions, and advertising restrictions may do). In the absence of any search frictions, the law of one price would prevail and, in the absence of any restrictions, intense competition would not allow retailers to earn any margins. If a manufacturer with market power wanted to

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8 A minimum RPM provision sets a minimum price at which a retailer can sell the goods of a manufacturer.

9 Baye, Morgan & Scholten (2006), "Information, search, and price dispersion" in Handbook on Economics and Information Systems, Hendershott (ed.), 323-375 at p. 323.

10 European Commission - Press release Antitrust: Commission fines Google €2.42 billion for abusing dominance as search engine by giving illegal advantage to own comparison shopping service, June 27, 2017 available at: http://europa.eu/rapid/press-release_IP-17-1784_en.htm.

11 See Economic Sciences Prize Committee of the Royal Swedish Academy of Sciences, "Scientific Background on the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2010: Markets with Search Frictions" (October 2010), which describes Diamond (1971), A Model of Price Adjustment, Journal of Economic Theory 3, 156—168 as laying out the "Diamond paradox" that "a small search friction can have a large effect on price outcomes, and it would not lead to any price dispersion at all." Available at: http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2010/advanced-economicsciences2010.pdf.

allow its retailers to earn margins, then imposing an RPM regime with a retail price above the wholesale unit price provides one means of doing so.[12] To see this, and continuing with the example above, one action that the manufacturer might take is to set an RPM price of 10. Alternatively, the manufacturer could impose a vertical restriction that reduces price transparency (for example, MAP at a price of 10 or a ban on advertising).[13] Then, consumers would have to search among retailers to see the true price, and, as the logic of the Diamond paradox in the paragraph above suggests, this would also lead to a retail price of 10.

It is noteworthy, however, that Diamond's result is termed a paradox for a reason: It is a theoretical result that seems to contrast with observed prices. Building on this observation, a literature in economics responds to Diamond's result by arguing that the underlying assumptions may be too stark and suggesting that in reality, goods may not be identical, consumers might vary in their search costs and in their valuations of goods and that retailers differ in their costs of bringing the wholesale good to market, or that the search process may differ slightly from that suggested in Diamond's model.[14]

Many of these departures from Diamond's model suggest that advertising restrictions may operate quite differently from price restraints.

IV. NON-EQUIVALENCE BETWEEN RPM AND MAP OR OTHER ADVERTISING RESTRICTIONS

Whereas price restraints tend to lead retailers to charge similar prices, advertising restraints can make it easier to sustain retail price dispersion — that is, to allow different retailers to charge different prices or different consumers to face different prices. In an environment that features heterogeneous consumers and/or heterogeneous retailers, a manufacturer can benefit from such price dispersion.

As a simple example, extend the setting above to suppose that only half of the consumers have a valuation of 10 and the other half have a valuation of 15. Further suppose that all retailers (perhaps through use of cookies and tracking technologies) can perfectly observe the valuation of any consumer who visits them. In the absence of any restrictions and with frictionless consumer search (for instance, via truthful competitive advertising or transparency via a price comparison site), identical retailers competing only through prices would all charge the same price to all consumers. RPM could help ensure that retailers earn margins and that the retail price is either 15 or 10 (either may maximize the combined industry profits, depending on the industry cost structure).[15]

By contrast, an advertising restriction, by creating a friction inhibiting a consumer's ability to see prices across all retailers, could allow retailers to charge different types of consumers different prices. This could lead to higher industry profits, which could be shared by retailers and the manufacturer through fixed franchise, licensing or other similar fees and hence could benefit both retailers and manufacturers.[16]

In this example, MAP provisions can facilitate a form of retailer-based price discrimination, which is unavailable using RPM. This arises through the suppression of information by the MAP provision coupled with the flexibility in pricing retained by the retailers relative to RPM. Furthermore, it may be that consumers with lower valuations benefit from this discrimination, as the retailer's ability to offer them lower prices means that they may not be priced out of the market.

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12 As discussed below, there may be pro-competitive reasons to do so as suggested by Telser (1960), "Why Should Manufacturers Want Fair Trade?" *Journal of Law and Economics*, 3, 86-105, among others. Asker & Bar-Isaac (2014), "Raising Retailers' Profits: On Vertical Practices and the Exclusion of Rivals," American Economic Review, 104(2), 672-686, highlight that there may also be anti-competitive reasons for doing so in fostering exclusion, while a large literature has considered the role of RPM in allowing for collusion.

13 There is a literature that has focused on the incentives of individual retailers to obfuscate prices. A useful overview is Fisher Ellison (2006), "Price Search and Obfuscation: An Overview of the Theory and Empirics," Chapter 12, *Handbook on the Economics of Retailing and Distribution*, Basker (ed.), 287-305. Here, instead, we consider the incentives of an upstream manufacturer in a vertical chain with several downstream retailers.

14 Baye, Morgan & Scholten (2006), "Information, search, and price dispersion" in Handbook on Economics and Information Systems, Hendershott (ed.), 323-375, provides a clear and useful introduction and guide to this theoretical literature.

15 In fact, RPM is not required to ensure that the price is either 10 or 15; the manufacturer could ensure this through varying the wholesale price; however, this would not entail a profit for retailers without the use of direct transfers from the manufacturer, such as slotting fees. If the manufacturer wished to induce a margin per unit, then RPM would be of use.

16 See Asker & Bar-Isaac (2017), Vertical Information Restraints: Pro- and Anti-Competitive Impacts of Minimum Advertised Price Restrictions, NBER Working Paper No. 22771.

V. FURTHER PRO- OR ANTI-COMPETITIVE EFFECTS

The example above is sufficient to show that advertising restrictions can behave quite differently from pricing restrictions. In a recent working paper ("Vertical Information Restraints: The Pro- and Anti-Competitive Impacts of Minimum Advertised Price Restrictions"), we consider several other cases and highlight that MAP, advertising restraints, and other vertical restraints that affect search frictions can have pro- or anti-competitive effects relative to either no restraints or to RPM. In all these cases, the search frictions that such restraints foster allow for different prices to prevail in the retail sector. These prices can lead to higher industry profits by, as above, giving retailers more flexibility to respond to heterogeneity (in either consumer demands or in retailer costs).

In a first case, similar to the example, we consider how such restrictions lead to an arrangement akin to price discrimination but at the level of the retail industry rather than that of individual retailers in a market where each retailer must charge the same price to every consumer. Instead of individual-retailer-level price discrimination, a related outcome arises when consumers vary in both their costs of searching and in their valuation of the good. Special attention is given to the case in which these consumer characteristics are related, so that those with high valuations also have high costs of search (for example, these may correspond to consumers with high incomes and high opportunity costs of time). In this setting, consumers with high valuations search little and are more likely to buy from retailers who charge a high price, whereas consumers with lower valuations who shop around are more likely to find retailers selling at lower prices. Through appropriate wholesale arrangements, a manufacturer can benefit from the industry-level profits that would result. These would be greater than those that could be realized when all retailers charge the same price — the outcome that would arise in the absence of any advertising or informational restraints. Furthermore, this discrimination-like outcome could lead to higher or lower total surplus depending on whether more or fewer consumers are served.

More generally, the voluminous literature on vertical restraints suggests numerous pro- and anti-competitive effects of price-based restraints. The U.S. Supreme Court's 2007 *Leegin* decision provides an interesting and policy-relevant summary that highlights how the weight of economic evidence led the court to conclude that the antitrust impact of RPM should be decided on a rule-of-reason basis. In essence, pro-competitive rationales suggest that RPM, by suppressing intra-brand competition, can foster inter-brand competition or otherwise lead to efficiency-enhancing investments by retailers (such as educating sales staff, efforts in enhancing or maintaining a premium reputation or stocking a good in the face of uncertain demand). In an online context, such concerns may be heightened as some consumers visit brick-and-mortar stores to better understand the products and buy online, or, in other ways, retailers free-ride off other retailers' investments. However, there remain concerns of the anti-competitive effects that RPM may have in facilitating either upstream or downstream collusion and facilitating exclusion.

Consequently, it is instructive to revisit some classical pro-competitive rationales (service provision where retailer free-riding may arise) and anti-competitive rationales (upstream collusion) with MAP provisions in mind. Advertising restrictions, such as MAP, can allow a manufacturer to accommodate retailer heterogeneity, allowing retailers with different costs of bringing goods to market (or whose costs may fluctuate over time) to respond to their differing costs by charging differing prices. Similarly, retailers with different local market conditions may benefit from the flexibility of MAP, while still benefiting from a reduction in intra-brand competition afforded by the obfuscation of transaction prices that MAP provides. This can allow a more effective means of providing margins that in turn incentivize retailers to provide services to consumers. Of course, if the objectives of manufacturers and consumers are not aligned, then the service that is provided, although benefiting manufacturers, may be detrimental to consumers. Many vertical theories of cartel-facilitation and exclusion have this flavor, and as such it is no surprise that MAP can be effective in supporting cartel behavior, particularly in settings where consumer search matters. By contrast, the "one-size-fits-all" RPM policy may be less effective in achieving either pro- or anti-competitive goals.

In addition to the range of effects that advertising restrictions might have, how consumers search is very important — both in the absence of any restrictions (where there should be greater price transparency and all consumers can find the lowest prices easily) and in the presence of such restrictions (where search frictions should be more pronounced).

VI. POLICY IMPLICATIONS

Thus far, this article has argued that advertising and related restraints are common and in an ecommerce environment may be increasingly so. These restraints can have different economic effects and rely on different logic compared to the types of price restraints that have been extensively explored in the literature and by antitrust authorities and the courts.[17] Furthermore, recent developments suggest that there may be a lack of clarity on this distinction.

Notably, the CMA, in its decision on *Online resale price maintenance in the commercial refrigeration sector*, and earlier Office of Fair Trading decisions,[18] has suggested that MAP provisions operate in much the same way as other restraints that constitute a restriction "by object" under Article 101(1). For example, the CMA's press release at the conclusion of the *commercial refrigeration sector* case states that: "The CMA found that Foster's minimum advertised price policy constituted RPM because, by restricting the price at which its goods were advertised online, it prevented dealers from deciding the resale price for those goods."[19]

Indeed, following the decision on the commercial refrigeration sector, the CMA issued an open letter to suppliers and retailers on June 20, 2016 and updated it on June 21, 2017 following its decision *Online resale price maintenance in the light fittings sector*.[20] This guidance, while perhaps more circumspect than the statement above, suggests that the regulator's distinction between MAP and RPM agreements is subtle at best.[21]

Therefore, this seems to be an opportune time to highlight that the underlying economics of MAP and other advertising and related practices can differ from those of RPM and other, similarly well-understood, vertical restraints. Treating information restrictions (such as MAP) as a form of price restriction (such as RPM) seems premature in our view. There appear to be good reasons for the regulatory approach to such practices to develop further with reference to, but separately from, that applied to price restraints. This is particularly so given the growing use and range of these practices in ecommerce and the opportunity this affords to gain further insight into their pro- and anti-competitive impacts on a case-by-case basis.

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17 However, there is some precedent on MAP as discussed in a U.S. context by Beth Albert (2012), "Adding Uncertainty to the Virtual Shopping Cart: Antitrust Regulation of Internet Minimum Advertised Price Policies," *Fordham Law Review*, 80(4), 1679-1719, and Passo (2015), "Internet Minimum Advertising Price Policies: Why Manufacturers Should Be Wary When Implementing," *Suffolk University Law Review*, 48, 795-822. Background on the UK and EU treatments can be found in Hughes (2017), "Bright line or barbed wire? The classification of supplier influence over resale prices under EU competition law," *European Competition Law Review*, 38 (6), 272-287.

18 *Online resale price maintenance in the commercial refrigeration sector*, Case CE/9856/14; *Lladró Comercial*, CA98/04/2003 [2003] UKCLR 652; *Pride Mobility Products Ltd.*, Case CE/9578-12, March 27, 2014; *Roma-branded mobility scooters: prohibitions on online sales and online price advertising*, Case CE/9578-12, August 5, 2013.

19 *Fridge supplier fined £2.2 million for restricting online discounts*, available at: https://www.gov.uk/government/news/fridge-supplier-fined-22-million-for-restricting-online-discounts.

20 *Open letter to suppliers and retailers about resale price maintenance (RPM) and compliance with competition law 20 June 2016*, available at: https://www.gov.uk/government/publications/restricting-online-resale-prices-cma-letter-to-suppliers-and-retailers.

21 Hughes (2017), "Bright line or barbed wire? The classification of supplier influence over resale prices under EU competition law," *European Competition Law Review*, 38 (6), 272-287 provides a forceful and wide-ranging critique of regulatory practice on MAP.

ARE PRICE PARITY CLAUSES NECESSARILY ANTICOMPETITIVE?

BY THIBAUD VERGÉ[1]

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I. INTRODUCTION

Price parity clauses, also referred to as retail most-favored nation clauses, have recently triggered several antitrust investigations, almost all of them in markets involving intermediation platforms and agency business models (i.e. where suppliers keep control of final prices). Such clauses are frequently imposed to suppliers by intermediation platforms, each platform attempting to guarantee the best available price for a given product to its final consumers.

Price parity clauses were considered about five years ago during the investigations against Apple and leading publishers in Europe and in the U.S., but the main focus was on explicit anticompetitive agreements between Apple and six large publishers.[2] In May 2017, the European Commission accepted commitments from Amazon to abandon price parity clauses.[3] During this investigation, started in 2015, "the Commission considered that such clauses could make it more difficult for other e-book platforms to compete with Amazon by reducing publishers' and competitors' ability and incentives to develop new and innovative e-books and alternative distribution services" *(European Commission Press Release, May 4, 2017)*

A few years before, Amazon had already been the subject of antitrust investigations by the UK Office of Fair Trading ("OFT") and the German Bundeskartellamt ("BKartA"), but the cases were dropped in 2013 after Amazon announced its plan to abandon the price restrictions on Amazon Marketplace across the EU. In September 2014, the UK Competition and Markets Authority ("CMA") ended its investigation of private motor insurance concluding that wide price parity clauses imposed by price comparison websites ("PCWs") were likely to harm consumers (although the CMA did not identify any antitrust violation) and ordering a ban on such clauses that apply across the board, though allowing narrow price parity, a practice that guarantees a PCW not be undercut by a supplier's direct distribution channel.[4]

Similar issues have been debated in cases against payment card systems in the U.S., Europe and many other jurisdictions, regarding the no surcharge rule that prevents merchants from charging a higher price for card payments than for cash payments.[5]

Although price parity clauses have been the subject of investigation in relation to various markets, the online booking market is probably the sector that has concentrated most of the cases with possibly conflicting outcomes in different jurisdictions.[6] Investigations started a few years ago in the UK and Germany.

In December 2013, the BKartA reached a decision against HRS, a leading online travel agency ("OTA") on the German market, and prohibited its price parity clauses.[7] In December 2015, it reached a similar decision against Booking.com and an investigation of Expedia is ongoing.[8]

In a parallel investigation, the OFT accepted, in January 2014, commitments offered by Booking.com, Expedia and Intercontinental Hotels Group. The OFT's focus was not directly on the price parity clauses but rather on the platforms' ability to offer discounts to final consumers (by giving back part of their commission). The accepted commitments thus concentrated on the platforms' ability to offer rebates to "closed consumer groups" rather than on banning best price clauses. This later led the UK Competition Appeals Tribunal to overturn the decision, but, in September 2015, the CMA (in charge of launching a new investigation) dropped the case although it "committed to 12 months of on-going monitoring of market developments."[9]

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2 See the European Commission's decisions in Case COMP/39847/*E-Books* (2012, 2013) and *United States v. Apple Inc.*, 952 F. Supp. 2d 638, 15 647 (S.D.N.Y. 2013).

3 See the European Commission's decision in Case COMP/40153/*E-Books MFNs and related matters* (May 4, 2017).

4 See the CMA's final report and notice of order on the Private motor insurance market investigation respectively published on September 24, 2014 and March 18, 2015, both available at: https://www.gov.uk/cma-cases/private-motor-insurance-market-investigation.

5 As part of settlements with the US Department of Justice, Visa, Mastercard and American Express have all accepted to stop imposing any no-surcharge rule.

6 For a detailed description of the cases, see Hviid (2015), "Vertical Agreements Between Suppliers and Retailers That Specify a Relative Price Relationship Between Competing Products or Competing Retailers," paper prepared for the OECD Competition Committee Hearing on Across Platform Price Parity Agreements; and, González-Díaz & Bennett (2015), "The law and economics of most-favoured nation clauses," *Competition Law & Policy Debate*, 1(3), pp. 26-42.

7 Bundeskartellamt, *Hotel Reservation Service (HRS)*, Case B 9-66/10. This decision was later confirmed by the Düsseldorf Higher Regional Court [Düsseldorf Higher Regional Court (OLG), VI - Kart. 1/14 (V)].

8 Bundeskartellamt, *Booking*, Case B 9-121/13.

9 OFT 1514dec; [2014] CAT 16; CMA decision (September 16, 2015) to close the case CE/9320-10.

Several EU countries later started investigations and, in April 2015, the French, Italian and Swedish competition agencies simultaneously accepted commitments offered by Booking.com that included a switch from wide to narrow price parity clauses.[10] Booking.com unilaterally extended those commitments to the other European Economic Area Member States, and Expedia soon followed suit. The Swiss Competition Commission (October 2015) and the Australian Competition and Consumer Commission (September 2016) also "banned" (through formal prohibition or commitments) wide price parity clauses but allowed narrow clauses.[11]

Yet, it did not all end there. During the summer 2015, the French parliament voted to prohibit any form of price parity (or control by the platforms) for hotel room bookings. They were soon followed by their Austrian (January 2016) and Italian (August 2017) colleagues.

In the U.S., antitrust agencies did not intervene, and, in February 2014, the District Court of the Northern District of Texas decided against plaintiffs in a class action against hotel chains and OTAs.[12]

What is striking from these various cases, is that despite reaching different conclusions – some agencies or governments choosing to ban all kinds of price parity clauses (Germany, France, Austria, Italy), while others only required a switch from wide to narrow price parity only (other EU countries, Switzerland, Australia) – they all relied on a relatively similar theory of harm. The common view is that price parity clauses limit competition between platforms on commission rates, ultimately leading to higher prices being charged to consumers. When wide price parity clauses are used by platforms, a supplier has to set the same price on all of them as well as on its direct distribution channel. In this case, each platform has an incentive to increase its commission above the "competitive" level since it does not risk losing market share to its rivals. This ultimately leads to supra-competitive commissions being charged by platforms and thus to higher prices being charged by suppliers to final consumers. As we will see in what follows, the validity of such a theory of harm relies on the implicit assumption that suppliers cannot avoid being listed on all platforms.

The differences in approaches – regarding the final outcome – may be explained by variations in market structure in different geographic markets, but they may also reflect the fact that economists have not yet reached a consensus on the competitive effects of such price parity clauses.

II. ACADEMIC RESEARCH: NO CONSENSUS YET

A. Theoretical Analysis

Although there exists a large body of literature on the effects of wholesale MFN clauses, the academic research on the competitive effects of platform price parity clauses is still relatively scarce. The earlier papers, inspired by the *EBooks* cases, have focused on the impact of a switch from the traditional retailer model (where platforms such as Amazon acquired e-books from the publishers at a negotiated wholesale price and were then setting prices charged to final consumers on their platforms) to the agency model (where publishers keep control of the final prices and pay commissions to platforms for all sales). In a setting where consumers first acquire a device such as a reading tablet or mobile phone before prices for books or mobile applications are set, Gans (2012) showed that a price parity clause could help solve a hold-up problem and thus be welfare–enhancing.[13] Focusing on the choice of business format (retail or agency model) by platforms, Foros, Kind and Shaffer (2016) show that even if commission rates do not change (for exogenous reasons) when price parity clauses are introduced, such clauses may facilitate the adoption of the agency model which, in turn, may lead to higher consumer prices.[14]

The literature focusing on the effects of price parity clauses in the agency model has approached the issue of price parity clauses from two different angles.

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10 Autorité de la concurrence, Case 15-D-06; Konkurrensverket, Case 596/2013 ; Autorità Garante della Concorrenza e del Mercato, Case I779 B.

11 Competition Commission (COMCO/WEKO), *Online-Booking Platforms for Hotels*, Decision of October 19, 2015; ACCC media release MR 158/16 (eptember 2, 2016), available at: https://www.accc.gov.au/media-release/expedia-and-bookingcom-agree-to-reinvigorate-price-competition-by-amending-contracts-with-australian-hotels.

12 *In re Online Travel Company (OTC) Hotel Booking Antitrust Litigation*, Case No. 3:12-cv-3515-B (N.D. Tex., Feb. 18, 2014).

13 Gans (2012), "Mobile Application Pricing," *Information Economics and Policy*, 24, pp. 52-59.

14 Foros, Jarle Kind & Shaffer (2016), "Apple's Agency Model and the Role of Most-Favored Nation Clauses," *Rand Journal of Economics*, 48(3), pp. 673-703.

A first strand of papers focuses on more traditional vertical relationships models, with suppliers competing on the downstream market and buying intermediation services from the platforms (platforms thus compete on the upstream market to provide services to the downstream firms). Platforms are usually assumed to have all the bargaining power *vis-à-vis* suppliers and thus setting commissions (or commission rates) through take-it-or-leave-it offers. Suppliers then decide which distribution channels to use and set prices charged to final consumers. Boik and Corts (2016) consider a simple framework in which two (differentiated) platforms compete to offer intermediation services to a monopolist supplier. Assuming that the supplier is constrained to sell through both platforms if it decides to be active on the final market, they show that price parity clauses soften competition between intermediaries and thus increase the prices charged to final consumers.[15] In addition, such clauses also reduce the incentives for low-cost platforms to enter the market. In an earlier version of his paper, Johnson (2017) extended this result to multiple suppliers and any number of platforms.[16] In both papers, the intuition for this anticompetitive effect of price parity clauses is identical to the theory of harm put forward by competition agencies in the European cases on hotels booking platforms.

Johansen and Vergé (2017) extend the earlier models allowing suppliers to compete with the platforms to attract final consumers (i.e. direct sales) and to select whether to be active on platforms or not.[17] Once these two important features are added to the model, they show that price parity clauses are not always harmful to suppliers and consumers. When suppliers are sufficiently close substitutes, price parity clauses may indeed lower commissions as suppliers would otherwise be tempted to delist from an expensive platform to become more competitive (and thus substantially increase their market share) in the remaining channels. However this result only holds when direct distribution is a sufficiently good substitute for intermediation platforms otherwise the threat of delisting would not be effective.[18]

Pure vertical relationship models do not account for some important features of online intermediation platforms: for instance, these platforms help consumers to find the best product and offer additional services or benefits on which suppliers could attempt to free-ride by letting consumers search on the platforms and then attempting to divert them to their direct distribution channels.

A second strand of literature tries to incorporate such features in the models. Wismer (2013) – in a model inspired by the no-discrimination rule sometimes imposed for credit cards – introduces a simple model in which consumers start searching for the best supplier on one distribution channel (the "monopolist" platform or the sellers' direct distribution channels) and then observe all available prices for their selected product.[19] In this setting, he shows that price parity clauses do not necessarily lead to an inefficient allocation of sales across channels and their impact will actually depend on different parameters including the magnitude of the cost faced by consumers to switch channels.

Introducing a risk of showrooming (i.e. the possibility to attract consumers who search on the platform by offering lower prices in the direct distribution channels), Wang and Wright (2017) consider how price parity clauses may help prevent showrooming, thus guaranteeing the platforms' economic viability.[20] However, consumers do not necessarily benefit from the reduced search cost on the intermediation platforms since this surplus can be fully extracted by the platform through higher commissions.[21] With competing platforms, wide price parity clauses remains harmful for consumers but they may benefit from narrow price parity clauses. Wang and Wright (2016) extend the previous model to allow for platform investment and show that all the benefits generated by increased investment can again be extracted through commissions and thus do not necessarily benefit to final consumers. Investment may also be excessive (leading to too high prices on the final market) when price parity is in place, a point also made by Edelman and Wright (2015).[22]

15 Boik & Corts (2016), "The Effects of Platform Most Favored-Nation Clauses on Competition and Entry," *Journal of Law and Economics*, 59, pp. 105-134.

16 Johnson (2017), "The Agency Model and MFN Clauses," *Review of Economic Studies*, 84(3), pp. 1151-1185.

17 Johansen & Vergé (2017), "Platform Price Parity Clauses with Direct Sales," *University of Bergen Working Paper 01/17*.

18 See also Rey & Vergé (2016) who show that price parity clauses have no impact on marginal commission rates when commissions can be non-linear (for instance including a fixed component and a constant price per sale). In this case, the only impact of price parity clauses is to lead to uniform prices [Rey & Vergé (2016), "Secret Contracting in Multilateral Relations," *TSE Working Paper n°16-695*].

19 Wismer (2013), "Intermediated vs. Direct Sales and a No-Discrimination Rule," *Working Papers 131*, *Bavarian Graduate Program in Economics*.

20 Wang & Wright (2017), "Search platforms: showrooming and price parity clauses," mimeo.

21 Ronayne (2015) makes a similar point showing that price comparison websites may not necessarily increase consumer surplus as they can extract the surplus they generate through the commissions charged to participating sellers [Ronayne (2015), "Price Comparison Websites," mimeo].

22 Wang, Chengsi & Wright (2016), "Platform investment and price parity clauses," mimeo; Edelman & Wright (2015), "Price Coherence and Excessive Intermediation," *Quarterly Journal of Economics*, 130, pp. 1283-1328.

B. Empirical Evaluations

Since the theoretical models are not conclusive and suggest that the effects of price parity clauses on consumer surplus or suppliers' profits may be ambiguous, economists have tried to empirically evaluate their effects. Some of them have tried to take advantage of the recent investigations in the hotel cases to collect data before the decisions where effective to propose before-and-after analysis or even difference-in-differences approaches.

Two recent academic papers use price data scrapped from metasearch sites such as Kayak or Trivago. Hunold et al. (2017) evaluate the effect of price parity clauses on price dispersion and on the frequency with which one platform (namely Booking.com) exhibits the lowest price.[23] However, their empirical evaluations have so far focused more on price dispersion than on price levels or on commission levels, thus the common theory of harm has not yet been directly tested. According to Mantovani, Piga and Reggiani (2017), the evidence suggests that hotel prices decreased in 2015 (the year Booking.com's commitments were accepted) but bounced back in 2016.[24] But the analysis is focused on one-night bookings in the touristic islands of Sardinia, Sicily, Corsica and the Balearic Islands where one can presume that consumers stay for more than one night. Moreover, the commitments only entered into force in July 2015, thus 2015 prices combined before and after prices. It is thus quite difficult to draw any conclusion on the effects of price parity clauses from their analysis.

European competition agencies have also tried to carry out empirical evaluations of the effects of price parity clauses. But once again, the focus has been on price dispersion rather than on price levels when it may have been easier for them to collect the relevant data (on commissions) to directly evaluate the validity of their common theory of harm. If anything the results of their evaluation suggest that the ban of wide price parity clauses in most EU countries (and of all price parity clauses in Germany and France) has not been very effective. In a press release that followed the publication of its interim assessment of the commitments offered by Booking.com, the French *Autorité de la concurrence* concluded that:

> The assessment results held by the Autorité may suggest that more hoteliers are now varying their prices according to the online hotel booking platforms. This price difference is evidence of an initial change in the sector, though without any visible sign of increased competition among OTAs, based on other more qualitative or quantitative criteria (market share, quality of the offering, change in commission rates).[25]

The European Competition Network ("ECN") working group similarly concluded that:

> Very few hotels said that they engaged in trade-offs whereby they grant OTAs more favourable room prices or room availability in return for a lower commission rate. (…) According to evidence obtained from certain OTAs, the average effective rates of commission paid by hotels (basic commission plus optional additional commission) remained relatively stable or slightly decreased in almost all participating Member States in the period from January 2014 to June 2016. This was also true for France and Germany.[26]

Only one attempt has been made to look directly at the effect of price parity clauses on commissions. In March 2015, after a two-year market investigation, the CMA decided to prevent price comparison websites from using wide price parity clauses in their relationships with private motor insurance providers.[27] In September 2017, the CMA ended its market study on Digital comparison tools during which it carried out an econometric analysis of the commissions charged by price comparison websites to private motor insurance providers between 2010 and 2016.[28] In this report, the CMA concludes that the removal of wide price parity clauses by the leading price comparison websites led to a

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23 Hunold, Kessler, Laitenberger & Schlütter (2017), "Evaluation of best price clauses in hotel booking," mimeo (earlier version published as *ZEW Discussion Paper n°16-066)*.

24 Mantovani, Piga & Reggiani (2017), "The Dynamics of Online Hotel Prices and the EU Booking.com Case," *NET Institute Working Paper #17-04*.

25 *Autorité de la concurrence*, Press release dated February 9, 2017, *Hotel booking platforms*. Available at: http://www.autoritedelaconcurrence.fr/user/standard.php?id_rub=663&id_article=2945&lang=en.

26 ECN working group (2017), *Report on the Monitoring Exercise Carried Out in the Online Booking Sector by EU Competition Authorities in 2016*, September 2017.

27 See the CMA's final report and notice of order on the *Private motor insurance market investigation* respectively published on September 24, 2014 and March 18, 2015, both available at: https://www.gov.uk/cma-cases/private-motor-insurance-market-investigation.

28 See Appendix 2: DCT Commissions and wide MFNs (Econometric Analysis) of Part E of the CMA's final report on the *Digital comparison tool market study* published on September 26, 2017, available at: https://www.gov.uk/cma-cases/digital-comparison-tools-market-study.

decrease of about three percent of the commissions charged to insurance providers. One may nevertheless worry about the source of variation in the commissions over time since the ban on wide parity only came into force after March 2015 and the post-order data covers a very short period.

III. WHAT CAN WE CONCLUDE AT THIS STAGE?

Despite the number of cases over recent years, no consensus has been reached by competition agencies on the competitive effects of price parity clauses: there seems to be a consensus among European agencies (and maybe some others) that wide price parity clauses restrict competition between platforms on commissions' rates and may also prevent entry by innovative low-cost platforms. However, even within the ECN, agencies seem to disagree on the effect of narrow price parity clauses.

In a similar way, no consensus has been reached among economists who proposed potentially conflicting theoretical results. Moreover, there is still a lack of satisfactory empirical evidence on the effects of price parity clauses (and possibly on the differences between wide and narrow price parity).

Although more work needs to be done by academics and competition agencies to better understand the role of different factors (competition between platforms and/or suppliers, importance of direct sales, etc.) that may affect the commissions negotiated between platforms and suppliers with and without price parity, we can still draw some insights from the existing body of theoretical literature.

One important factor that affects the theoretical effects of price parity clauses on commission rates seems to be the ability of suppliers to threaten platforms to delist in case the commissions are considered to be too high. The credibility of such a threat will indeed affect the platforms' ability to raise commission rates (especially when price parity clauses are imposed by several large platforms) above the competitive level. Therefore, price parity clauses are unlikely (or much less likely) to have adverse effects on commission rates – and thus on prices paid by final consumers – when suppliers can reasonably be expected to delist from a platform which would try to charge "excessive" commissions. Whether suppliers can credibly threaten to delist from a platform depends on their ability to divert the lost sales towards more profitable distribution channels and especially towards direct sales.

For instance, one may well believe that it would be difficult for small suppliers that cannot rely on a well-known brand to threaten to leave a large marketplace such as Amazon. This thus suggests that a price parity clause imposed by Amazon to small suppliers may indeed have the potential to harm suppliers and final consumers. On the contrary, large insurance companies may find it much less costly not to be active on a price comparison website that would charge commissions that are too high. Therefore, one should expect price parity clauses to be less likely to lead to higher commissions and higher prices in this market.

Similarly, on the hotel booking platforms market, the effects of price parity clauses may well depend on the structure of the hotel market and on the role played by metasearch platforms such as Trivago, Tripadvisor or Kayak. Small independent hotels that rely on large platforms such as Booking or Expedia to attract consumers are less likely to delist from one of the platforms than large hotel chains that can use their well-known brand names (and own websites/booking platforms) to generate room bookings.

In 2012, several major hotels chains in Norway (First, Nordic Choice, Rica, Scandic and Thon) decided to leave Expedia's program and to instead promote their own websites.[29] After a rather lengthy "boycott," some of the chains restarted listing on Expedia in 2014, having renegotiated the commission rates charged by Expedia as well as price parity clauses imposed by the platform.[30] More recently, the U.S. hotel chain Hyatt considered ending its agreement with Expedia if they could not obtain "more reasonable and competitive commissions as well as improved flexibility on the OTA portals."[31] A few weeks later, in August 2017, Hyatt confirmed that it signed a new contract with Expedia. Hyatt's spokesperson was quoted saying that "[t]hese recent agreements with both Booking.com and Expedia allow us to achieve our goal of making Hyatt hotels available where many guests are booking while also reducing costs and improving flexibility," suggesting that they had managed to negotiate better terms with the two leading platforms.[32]

29 http://www.newsinenglish.no/2012/12/06/hotels-check-out-of-internet-giant/.

30 http://www.newsinenglish.no/2013/10/07/hotel-chains-cut-new-deals-with-online-giant/.

31 https://www.tourism-review.com/large-hotel-chain-to-leave-expedia-news5440.

32 https://skift.com/2017/08/18/hyatt-and-expedia-formally-sign-new-deal/.

HORIZONTAL SHAREHOLDING: A SUMMARY OF THE ARGUMENT

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I. INTRODUCTION

I will begin this short essay on horizontal shareholding with some background facts about institutional ownership. It has grown over the last 50 years and continues to grow. Institutions now own over 70 percent of the U.S. stock market.[2] Index funds are above 10 percent of the stock market, leaving a balance of about 60 percent in managed funds of different types.[3] Institutional investors have grown because savers gain from investing in funds that can diversify across stocks and have economies of scale. The largest four fund families hold about 5 percent of the stock market each (State Street, BlackRock, Vanguard and Fidelity). One of these funds is the largest shareholder in most of the S&P500.[4] There are other large owners that hold diversified stocks including competitors, e.g. Warren Buffet and sovereign wealth funds.

II. ABILITY

Corporate governance is an important function of institutional investors because they are large enough to have the incentive to gather information, engage in oversight, assemble votes to discipline management and monitor top management. Note that mutual funds technically do not "own" the stock but rather hold it for the ultimate investor. They have a fiduciary duty that gives them the right and responsibility to vote. Improved corporate governance is widely viewed as a useful consequence of the development of large funds. Some observers will claim that corporate governance is all box-ticking. If the corporation achieves metrics for independent directors, chairman/CEO roles, meets performance targets, incentive compensation, and so forth, then no large owner intervenes any further, and the whole exercise is somewhat mechanical. Another school of thought holds that corporate governance is real; owners engage with management over strategy, influence compensation and so forth. Below are some quotations taken from fund websites:

Blackrock 2013:

> We engaged with roughly 1500 companies around the world in 2012. When we engage successfully and companies adjust their approach, most observers are never aware of that engagement…
>
> We typically only vote against management when direct engagement has failed…engagement encompasses a range of activities from brief conversations to a series of one on one meetings with companies.

Blackrock 2011:

> Most of our engagements are nuanced and sensitive… we are extremely unlikely to use the media, make a statement at a shareholder meeting, propose a shareholder resolution, or employ other public means in our engagement process.

Vanguard 2011:

> Through engagement, we are able to put issues on the table for discussion that aren't on the proxy ballot.

This evidence suggests that the funds feel their corporate governance efforts are substantive and effective.

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2 McCahery, Sautner & Starks, Behind the Scenes: The Corporate Governance Preference of Institutional Investors, J. Fin. (forthcoming 2016), available at: http://onlinelibrary.wiley.com/doi/10.1111/jofi.12393/full; Rydqvist, Spizman & Strebulaev, Government Policy and Ownership of Equity Securities, 111 J. Fin. Econ. 70 (2014); Fichtner, Heemskerk & Garcia-Bernardo, Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk, CORPNET Working Paper (2016), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2798653.

3 As of 2010, institutional investors held common stock worth $11.5 trillion. Blume & Keim, Working Paper, Institutional Investors and Stock Market Liquidity: Trends and Relationships, The Wharton School, University of Pennsylvania (Aug. 21, 2012), available at: http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences_21Aug2012.pdf, at 20. In the same year, index funds held about $1.4 trillion. See Cremers, Ferreira, Matos & Starks, Indexing and Active Fund Management: International Evidence 36 (unpub. m.s. 2015). This implies that index funds compose 12 percent of the market. But index funds have grown considerably in the last few years, so the figure today is somewhat higher.

4 "As a consequence of their dominance in the asset management industry, a large and growing number of publicly listed companies in the United States face the Big Three—seen together—as their the largest shareholder...when combined, BlackRock, Vanguard, and State Street constitute the single largest shareholder in at least 40 percent of all listed companies in the United States....When restricted to the pivotal S&P 500 stock index, the Big Three combined constitute the largest owner in 438 of the 500 most important American corporations, or roughly in 88 percent of all member firms." P. 17 of Fichtner, Heemskerk & Garcia-Bernardo, "Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk," available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2798653.

III. INCENTIVE

Institutions benefit when the prices of the stocks they hold increase. Increasing portfolio returns often flow directly into managerial compensation and also benefit managers indirectly by increasing demand for their fund product.[5] Larger financial flows into funds typically increase their managers' compensation. However, funds have limited options to increase performance. They can make corporate governance improvements that they feel will improve management effort and therefore performance. Secondly, they can help managers make good strategic decisions directly.

There are many oligopolies in the U.S. economy, e.g. aluminum, breakfast cereal, carbonated beverages, airline travel, wireless carriers, seeds and more. In an oligopoly with sufficiently low industry elasticity of demand, all rival firms gain when they compete more softly and achieve higher prices. Oligopoly competitors often cannot achieve monopoly prices, and perhaps cannot even achieve prices very much above competitive levels due to imperfect information, lack of patience, asymmetry, and a host of other attributes that can create competition despite an oligopoly market structure.

A diversified fund will tend to hold rivals in an oligopoly if they are similarly large and listed on the same stock exchange. Of course, some may be private, or be listed on another (perhaps international) stock exchange. When a single owner owns two competitors, the common owner often does not gain from competition (e.g. lower prices). A single firm has an incentive to maximize only its own profits, the common owner has incentive to maximize joint profits.

IV. INCENTIVE AND ABILITY

The problem the literature has identified is that a large institutional fund has both the incentive to soften competition among portfolio firms, and through corporate governance communications, information flow, and creation of incentives, it also has the ability to soften the intensity of competition among portfolio firms.

A. Empirical Evidence

The empirical evidence that such behavior is indeed occurring is growing. The modern literature was initiated by Azar et al (2017) who study airline prices.[6] The first use the cross section of all routes and fares to relate the level of fares to common ownership of those airlines. They also exploit a fund merger to see if airline fares move as predicted when common ownership changes exogenously and sharply. They find support for the hypothesis outlined above. Additional empirical work is finding that horizontal shareholding causes higher prices or less relative competition in banking and in executive compensation, respectively.[7] The body of empirical academic work in this area is growing quickly and I expect the number of published papers in this area to rise in coming years.

B. Mechanism

Additional empirical literature may help pin down the mechanism through which the institutional investor softens competition. There are many such possible mechanisms. For example, the investor could provide advice and then vote against the CEO if he does not follow it. Alternatively, if each CEO hears strategic advice from the investor and knows the investor talks to rival CEOs, they realize they have common information. Such common information could render them less likely to make mistakes that disrupt cooperative pricing. Fund ownership may make executives more patient. The institutional investor could design or promote incentive packages for CEOs to reduce their incentive to compete against rivals. Diversified fund managers may decline to encourage portfolio firms to aggressively take market share away from rivals since market share is zero sum. A fund could choose not to cooperate with bids by activist investors interested in making one firm into an aggressive competitor. The current work points to executive compensation as one channel, but clearly there are many possible channels, and, moreover, the mechanism may vary across firms or owners. Determining the mechanism is an intellectually interesting project and it is also critical for designing a policy to mitigate any harms from horizontal shareholding. If the softening of competition can be shown to occur through a fairly precise channel, a policy could be chosen that eliminates that effect but perhaps not ownership itself.

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5 Chevalier & Ellison, *Career Concerns of Mutual Fund Managers*, 114 Q.J. Econ. 389 (May 1999), available at: https://doi.org/10.1162/003355399556034.

6 Azar, Schmalz & Tecu, *Anti-Competitive Effects of Common Ownership*, J. Fin, forthcoming.

7 Anton, Ederer, Gine & Schmalz, *Common Ownership, Competition, and Top Management Incentives* (June 1, 2017) (Ross School of Business Paper No. 1328; European Corporate Governance Institute; Azar, Raina & Schmalz, *Ultimate Ownership and Bank Competition* (July 23, 2016), available at: https://ssrn.com/abstract=2710252 or http://dx.doi.org/10.2139/ssrn.2710252.

V. ANTITRUST ENFORCEMENT OF HORIZONTAL SHAREHOLDING

The Clayton Act was passed in 1914 and controls asset acquisitions that tend to lessen competition. The original problematic organizational form for which the U.S. antitrust laws are named was the "trust." (The U.S. has "antitrust" law while the rest of the world has competition law.) The trust was a kind of holding company that allowed Gilded Age industrialists to buy up an industry (e.g. Rockefeller and Standard Oil) and combine them into one effective competitor. Therefore, enforcement against a large common owner of firms that would otherwise compete is familiar ground for U.S. courts, and is a topic on which there is already jurisprudence. In particular, readers may want to peruse the Supreme Court case *United States v. E.I. du Pont de Nemours & Co.*: "Even when the purchase is solely for investment, the plain language of § 7 contemplates an action at any time the stock is used to bring about, or in attempting to bring about, a substantial lessening of competition." 353 U.S. 586 (1957). In Hovenkamp and Scott Morton (forthcoming, Yale Law Journal) we discuss the legal case for liability for horizontal shareholding under both the Clayton Act and the Sherman Act. In the U.S., merger law applies when ownership is partial but to date these applications have been in settings of two or three firms buying or selling large minority stakes or engaging in JVs. The mutual fund setting is a modern variant of these earlier common ownership forms.

One important difference between horizontal shareholding and more standard merger analysis is the role of efficiencies. In this setting there are no efficiencies to the firm (e.g. Delta achieving lower costs) from being owned by one versus another owner (e.g. Wellington instead of Vanguard). Airlines do not operate more efficiently because their owner owns another airline. The benefits from such common ownership, namely diversification, accrue to the owners of the stock themselves who may be an almost entirely different set of people than airline consumers. Diversification also benefits the fund industry because its product becomes more attractive. But under *Philadelphia National Bank*, efficiencies in another industry cannot be used as a defense to anticompetitive conduct under the Clayton Act. Indeed, asking a judge to balance the concerns of investors with consumers being harmed by anticompetitive behavior in the airline market would require a court to rule in a much broader way than it would in a normal antitrust case. Ideally some elected part of the government determines policy for the mutual fund industry in order to make the best tradeoff between investors and consumers.

Some commentators have argued that the passive investment exception eliminates liability under the antitrust laws. But these rules are primarily about notification, not about anticompetitive behavior.[8] Passive investors do not have to *notify* an acquisition below a certain ownership threshold. Secondly, passive investing is not the same as passive ownership. We have seen above that funds are clearly not passive owners, nor would we want them to be, given the beneficial corporate governance that they provide.

A. Policy Concerns

If the legal liability for horizontal shareholding exists according to the precedent we describe, then courts will soon be ruling that particular funds may not hold particular product market competitors. For example, a court might find convincing evidence that four big funds' ownership of, for example, airlines, or of carbonated beverages, had raised prices. Such a court might then order a divestiture by the funds of the competing firms as a remedy. The nature of that divestiture would be tricky because the impact of ownership of a product market competitor depends on how many other competitors the fund owns, and on how many similarly-diversified owners there are. Thus compliance with the divestiture order might depend on the investment actions of other funds. Similarly, funds may perceive that when they hold stock in an oligopoly going forward, their exposure to liability depends on the holdings of other funds active in that same industry. Indeed, liability might be created when another fund buys and sells in that industry. This problem raises the question: how can a fund invest and be sure it is not lessening competition? And for society, how can we continue to support low-cost mutual fund saving? It seems clear that the government will have to develop a policy that protects competitive markets but also seeks to keep the fund industry as diversified and low cost as possible given the competitive constraint. Posner, Scott Morton and Weyl (2017) discuss one such option which I outline below.[9]

8 See Scott Morton & Hovenkamp, Yale Law Journal, forthcoming for more details on, and sources for, these points.

9 Posner, Scott Morton & Weyl, "A Proposal to Limit the Anti-Competitive Power of Institutional Investors," forthcoming in Antitrust Law Journal, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2872754.

B. Proposed Safe Harbor

> No institutional investor or individual *holding* shares of more than a *single effective firm* in an *oligopoly* may *ultimately own* more than 1% of the market share unless the entity holding shares is a free-standing index fund that commits to being *purely passive*.

A fund that followed this policy would not be prosecuted by the agencies under the antitrust laws; and we feel that private suits against compliant funds would have difficulty establishing liability in an environment where the government had declared liability to be minimal. Such a policy would allow a fund to avoid litigation and operate in a consistent and efficient manner. It would also allow the lowest cost index funds to maintain their business model. We define an effective firm size to be HHI/10,000. The rule thus boils down to a fund holding one firm in an oligopoly or collection of small fringe firms with a limited combined market share. The definition of an oligopoly firm would need to be created each year by an agency that would then publish a list along with market shares that could be used to calculate the HHI above. Clearly these oligopolies would not be antitrust markets; the list would only serve the purpose of mapping markets where the antitrust agencies are concerned about effective competition into ticker symbols which are the unit needed by fund managers to comply with the law. In our context "own" means any stock controlled and voted by the entire institution (across all funds it manages). A purely passive index fund engages in no communication, voting is mirrored and its assets or management is not combined with an active fund. Purely passive index funds would have to be free-standing entities with independent management companies. Any policy of this form would have to contain grace periods to transition holdings and other details covering practical considerations.

IV. SOCIAL WELFARE IMPACT

The social welfare impact of this type of policy could be high. In the U.S. we face a tradeoff: the investor wants a low cost, diversified vehicle in which to save, but the consumer wants low prices for goods she buys. The social planner should assess the empirical magnitude and incidence of horizontal shareholding on prices and diversification. Reducing a fund's ability to diversify raises the variance of investor returns. In principle there is no change in the mean risk-adjusted return from holding one airline instead of four, however, the higher variance reduces investors' utility. The amount by which investors' utility falls is likely to be small because the decline in variance from holding, e.g. the fourth airline, is low. On the other hand, an effective policy will lower the prices of oligopoly goods, creating a first-order increase in consumer utility. Secondly, the distributional impact of these changes is not even. Wealth holding in the U.S. is very concentrated; according to the latest Survey of Consumer Finances (2016), the top 10 percent of households own about 75 percent of total wealth. In addition, the top 1 percent hold many assets other than stock: real estate, private equity, hedge funds, foreign stocks, etc. Their S&P fund is likely not where they are getting diversification. If so, there is little harm from less diversification for both the top few percent of wealth holders as well as the bottom 50 percent of wealth holders. About half of U.S. household have no stock assets at all (including pension assets) and therefore can only experience zero harm from any horizontal shareholding policy. These consumers will benefit from any decline in horizontal shareholding that leads to lower prices. The upper middle part of the wealth distribution faces a tradeoff between the variance of their portfolio and paying lower prices for goods sold by oligopolies. In our paper we make a rough calculation of the tradeoff and conclude that on net it is overwhelmingly beneficial.

VII. CONCLUSION

The competition problem potentially created by horizontal shareholding by large institutional investors is one of the most important ideas in antitrust enforcement in recent years. The development of the literature is occurring quickly and will be needed to guide policy. Governments and policy makers will gain from focusing on these issues now and determining how to study and address them.

COMPETITION POLICY
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