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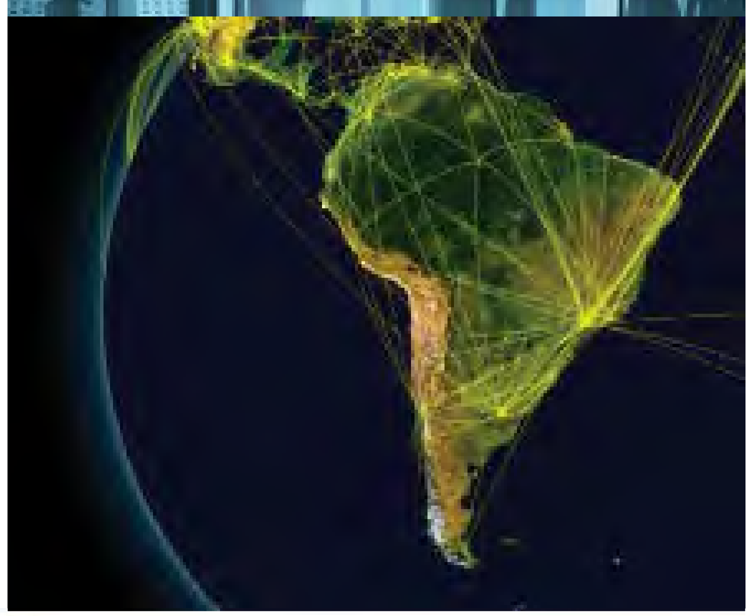

A SYMPOSIUM ON NEW BUSINESS MODELS

Alex Chisholm & Nelson Jung, Benjamin Edelman, Bruno Laserre, Thomas P. Brown & Molly Swartz and Damien Geradin

A SYMPOSIUM ON TENCENT CASE

Zhu li, Yong Huang & Roger Xin Zhang, Wei Huang & Guizhen Han and Antonio Bavasso, David S. Evans, Vanessa Yanhua Zhang, Daniel Sokol & Will Tom.

ARTICLES

Martin Cave & Ingo Vogelsang' Net Neutrality an EU/US Comparison.
Nicolas Petit's State Created Barriers to exit: the example of the acquisition of Alstom by General Electric.

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Letter From The Editor

This combined Spring-Autumn issue of the CPI Journal addresses the phenomenon of disruptive innovation and how the new Internet-based firms, and the so-called "sharing economy", are challenging competition and other regulatory authorities around the world.

We have witnessed, in particular, the rise – and sometimes fall- of Uber in different cities in most of the countries with competition laws. Regulators debate whether to allow a service pretty much beloved by citizens because of its quality and efficiency or to shut it down because it doesn't follow the letter or intent of the laws, or otherwise challenges existing order. The issue isn't unique to Uber. Countries are facing a myriad of alternatives to tackle this problem. From adopting brand new regulations for this type of markets, to amend or try to fit in the current ones to simply leave markets decide what is best.

In our first symposium, we have contributions from leaders of two of the most prominent competition agencies in Europe. On the one hand, Alex Chisholm and Nelson Jung from CMA discuss how antitrust regulation ought to change and explain why more ex post and less ex ante regulation is required. In their opinion, blanket solutions are not appropriate and they fail to capture the specific circumstances these businesses operate in. Thus, acting prematurely with broad-brush ex ante legislation poses significant risk for business development and innovation.

On the other hand, Bruno Lasserre from the French Autorité de la Concurrence, also shares a skeptical view on adopting new regulations. Sometimes new business models only bring to light the competitive constrains and inadequacy of rules designed for traditional models and the proposed legislation only seek to perpetuate incumbents. Thus, caution is required when adopting new regulation. In his contribution, Bruno emphasizes the role of the new business models in the application of competition law and competition analysis, including market definition and market power, must account for the new model and its long-run impact.

Damien Geradin and Benjamin Edelman offer a completely different spin in their articles. With vast academic and professional experience in this field, their opposing views on the matter bring a vivid debate on whether Uber should be applauded or criticized for pushing legal and regulatory boundaries.

While answering this question would need more than a simple letter, Damien stresses the need to leave Uber operates until more legal certainty is achieved. In his view, it is not clear what are the legal requirements Uber shall comply with in some countries, thus, banning its services or adopting new rules may be equivalent to rise barriers to entry or forbid liberalization. Damien does not answer that question but clearly prefers to benefit from the efficiencies created. If a thing ain't broken, don't fix it.

Ben, unlike Damien, considers these legal loopholes "regulatory shortcuts" that Uber and other companies use to grow observing less than strict compliance with applicable rules. In his view, these new business models rather than competing on lawful activities are competing to circumvent and defy the law, what sometimes is achieved because of the huge customer support they get. This is an interesting point, Uber learned that regulators, if they wish to stop it, have to do so before Uber has a critical mass of consumer support. Otherwise, the political pressure may be so high that the cost of adopting new regulation will not outweigh its benefits.

Last in this symposium, we find Tom Brown and Molly Swartz article debating about new business models applicable to financial services, in particular to online marketplace for lending.

The second symposium is devoted to the quick-to-become-classic Tencent case, the first antitrust case decided by China's Supreme People´s Court (CSPC). This case is particularly relevant, not only because of the parties and the markets involved (big tech companies fighting in the online market) but also because of the ruling itself, where the court calls into question the traditional tools to define relevant markets and to determine market power. In just few years of practice, Chinese courts, regulators and practitioners are pushing boundaries beyond to what western regimes have accomplished in the last 20 years. It remains to be seen if this approach will succeed in the following years, but it takes courage to take these steps.

The first article by Huang Wei and Han Guizhen focuses on the consequences of this ruling on relevant market definition and market dominance determination. In their view, the ruling does not set aside the traditional tools to determine those factors, but it allows departing from the traditional analysis if circumstances require it. What is more, it is not even necessary to define relevant markets in special circumstances that apply in the particular case at stake with two sided markets in the online industry.

A similar approach is adopted by Yong Huang and Roger Xin Zhang in their article. These authors emphasize more the characteristics of the online markets to prove the necessity to have new tools for market definition. Compete for customer´s attention, time spent online, quality of the product, etc. are having a more prominent role than price itself.

Judge Zhu Li, one of the Supreme Court judges who decided the case, further analyses these features in his contribution. These characteristics pose tremendous challenges for the judiciary for different reasons: (i) the difficulty of ruling on fast moving Internet industries with old-fashioned laws and regulations that do not foreseen those situations. As Judge Zhu explained, courts are required to define legal boundaries by virtue of creative application of the law in every specific case; (ii) the difficulty of legal evaluation using methods for market definition and market dominance that do not fit to these new markets and (iii) the new demands for judicial relief that in most cases may be granted when it is too late for proper restitution.

Antonio Bavasso, Will Tom, Vanessa Zhang and I maintained an interesting discussion on the Tencent case. We touched on a variety of aspects, from the unusual in-depth review of economic evidence by the court, to the analysis of effects and even the burden of proof on abuse of dominance. All the authors acknowledged the sophistication of the judges' analysis to derive from traditional antitrust analysis for market definition and dominance and declaring the absence of dominance by Tencent. It also pointed out the importance of this judgment not only for China, but for global antitrust development.

Please note: In order to preserve the meaning and expressions from the original versions in Chinese, English translations may not be grammatically accurate in some parts. We apologize for this inconvenience.

To conclude our Journal, we include three articles from outstanding antitrust experts providing their views on current topics. The classic this year is dedicated to the Microsoft case. Keith Hylton offers a very interesting spin in his article where the more personal side of the case is discussed. This article brings to light the conflict between human frailty and the demands for judging. It is an interesting piece right now given the conflicts of the new tech companies with competition agencies and how the Microsoft decision could have tied American judges' hands for future cases.

Martin Cave and Ingo Vogelsang provides a EU/US comparison on net neutrality discussing which jurisdiction provides a more open and business friendly environment and when allowing or forbidding net neutrality would have positive effects. Last, Nicolas Petit offers a very interesting piece on barriers to exit conducting an empirical analysis, a topic barely examined in the economic literature, but that is it even more relevant when these barriers are created by the state in an attempt to help a national champion.

As always, we thank the contributors to this issue as well as our editorial team.

David S. Evans

A SYMPOSIUM ON NEW BUSINESS MODELS

Platform regulation — ex-ante versus ex-post intervention: evolving our antitrust tools and practices to meet the challenges of the digital economy

By Alex Chisholm & Nelson Jung [1]

I. INTRODUCTION

The rapid change in the economic environment, in particular the growth of the digital economy, poses challenges for competition authorities and policymakers alike: what are the key considerations that should inform the approach to intervention in such a fast moving sector?

Joseph Schumpeter showed that great historical waves of technological innovation clump together — canals, steam, steel and electricity, mass production and now — though he died too early to see it himself – Information Technology. In each epoch, the rules of the economy tend to be best adapted to the wave that has passed, not the wave that is breaking. It is the breaking wave that will bring with it tremendous new benefits to humanity, even if the merits of specific innovations and consumer behavior are often difficult to predict.

We are now seeing a wave of new innovations — ranging from Big Data methods of improving public health through epidemic detection to wearable technology such as life-logging cameras — and are presented with risks we have not encountered before.

As regulators, we have the responsibility but also the great historical privilege of playing an influential role in shaping the latest of these defining technological eras. We must realize that we are more likely to get it wrong if we act before we have evidence of harmful effects of disruptive technologies in digital markets. We must try to minimize the inevitable mismatch between how we have done things before and the opportunities and risks of the new breaking waves. This article discusses how antitrust regulation ought to change and explains why the authors believe this period requires more ex post and less ex ante regulation.

It focuses on three general points:

First, blanket solutions should be avoided. Instead, an evidence-based assessment of potential adverse effects of specific industry features or practices should be carried out before either ex-ante regulatory or ex-post enforcement tools are deployed. In either case this should be closely targeted to the specific harm identified, and every care should be given to avoid disproportionate actions and unwelcome side-effects. In that respect, online platforms and the digital economy do not differ from any other sector: there is no need to reinvent the regulatory wheel;

Secondly, significant risks associated with premature, broad-brush ex-ante legislation or rule-making point towards a need to shift away from sector-specific regulation to ex-post antitrust enforcement, which is better adapted to the period we are in, with its fast-changing technology and evolving market reactions.

Thirdly, as regulators, policymakers, businesses and consumers, we all need to adapt our practices to harvest the benefits of new, disruptive digital business models while containing their potential costs and risks.

II. BLANKET SOLUTIONS A POOR FIT FOR THE STILL-EVOLVING WEB

A. The Diversity Of 'Online Platforms'

What do we mean when we talk about "online platforms" potentially giving rise to competition concerns?

First, is not clear that the size of a platform, measured by revenue or number of customers, is necessarily indicative of competition concerns. Success in winning customers is not cause for suspicion or condemnation and size is not equivalent to dominance. Where companies do hold a dominant position, they have a "special responsibility" not to abuse that position and to compete on the merits, and must expect especially watchful scrutiny by the authorities. But dominance itself is not illegal.

Secondly, is there sufficient commonality in the evolving eco-system of the web to enable us to judge whether certain business models should be subject to regulation or enforcement action? It is certainly a challenge to determine what characteristics the following online models uniquely share: communications and social media platforms; operating systems and app stores; audiovisual and music platforms; e-commerce platforms; content platforms (itself a diverse group); search engines; payment systems; sharing platforms. The list could go on.[2]

Different platform characteristics will give rise to different issues, and regulation must remain case-specific if we are to minimize the risk of applying the wrong rule to a novel situation. By way of example: if a platform is processing consumer data, you may be concerned that the company adheres to privacy obligations regarding the processing of that data. At the same time, there might be a need to keep a watch on whether it acquires an unmatchable advantage over rivals through its exclusive control over such data. However, not all platforms process consumer data; and most of those that do, are unlikely to have market power. To the extent that some do, an even smaller group may have the ability and incentive to abuse that power. As a result, the analysis must be situation-specific.

Given the significant differences between the business models of the main digital platforms, one must be skeptical a priori about the extent to which any type of broad-brush legislation or economic regulation could provide satisfactory outcomes across such a wide variety of different situations.

B. No 'Digital One Size Fits All' – The Need For An Evidence-Based Approach

Lessons From The 'Net Neutrality' Debate?

Some commentators suggested that the recent debate on "net neutrality" may offer some insights as to whether the Internet and its ecosystems, including online platforms, would generally benefit from a greater degree of regulation.

Following a recent vote by the European Parliament, the first European-wide rules on net neutrality that will become a reality across all Member States from April 30, 2016.[3] The new rules seek to create legal certainty, avoid fragmentation in the European single market and are designed to preserve the openness of the Internet.

The Internet owes much of its success to the fact that it has been open and easily accessible.[4] A degree of regulation guaranteeing such openness therefore appears justified to protect the quality, affordability and universal access to the Internet as an open and unrestricted environment and as an engine of innovation.[5]

We are now hearing increasingly vocal calls to extend the Internet "neutrality" concept from the infrastructure layer to cover other, higher layers. However, does a perceived gradual "platformisation" of the Internet with a patchwork of multi-sided platforms operating different business models with differing levels of openness necessarily imply a need for "platform neutrality"[6] or other types of ex-ante regulation? [7]

We believe that the net neutrality debate offers only very limited lessons in respect of the pros and cons of online platform regulation. Evidence of specific issues relating to online platforms is required before regulation can be contemplated.

1. Insights From Recent Work In Digital Markets?

Our innate skepticism against broad-brush ex-ante regulation is reinforced by the recent work that the CMA has undertaken in digital markets. For instance, the CMA's report on the economics of open and closed systems, prepared together with France's Autorité de la Concurrence, confirmed that there is no "digital one size fits all". The report showed that openness is not necessarily always good for competition, nor are closed systems always bad.[8] For example, Apple's AppStore "walled garden" approach may reassure customers with quality and consistency, while Android's more open approach could allow for more entry and experimentation.

Similarly, in the CMA's competition work on price comparison websites we have also been careful to shape our interventions to reflect the particular circumstances of the markets concerned. Recent or ongoing CMA market investigations illustrate this: in Payday loans[9] and Retail Banking,[10] we wanted to encourage the development of price comparison websites; in Energy we have wanted to understand what could make them flourish; and in the Private Motor Insurance investigation we have sought to curtail certain contractual restrictions on competition, in particular "wide" Most-Favored-Nation clauses, which were found to give rise harmful effects.

The different approaches adopted in respect of each these examples illustrate that blanket solutions are not appropriate as they fail to capture the specific circumstances these business operate in.[11] Intervening without evidence that specific industry features or practices cause harm is putting the cart before the horse which rarely results in moving in the right direction.

C. When Might Online Platforms Give Rise To Economic Harm?

But are there not some common platform characteristics that might cause harm and that therefore can be tackled through common rules?

Online platforms exhibit fast-paced innovation and high rates of investment. However, the presence of network effects often makes it more likely that the "winner takes all". Once a market has "tipped", the platforms may have market power that could be used to discriminate against competitors or to the detriment of consumers and innovation.[12] Competition authorities should be concerned about the appearance of market power where it is sustained over a period of time and where there are significant barriers to customers switching or "multi-homing" that deter entry from more innovative or better platforms.

In the world of online platforms, barriers to switching may arise from a number of factors, including:

- Contractual restrictions imposed by the online platform. Examples include certain Most Favored Nation clauses or tying and exclusivity provisions;
- The inability of customers to transfer their reputation or profile to a competing platform, making consumers "invested" in a particular platform; and
- Proprietary data a dominant platform may have access to, for instance personal data or transaction history that is inaccessible to rivals and could in principle create an unmatchable advantage.

There may well be specific instances where online platforms can raise legitimate competition concerns, in particular when consumers are locked into a single unavoidable system with very limited contestability from competing systems.

However, both ex-ante regulatory and ex-post enforcement tools are likely to result in disproportionate actions and unwelcome side-effects if they are not carefully targeted at the specific harm. To achieve such carefully targeted intervention, there is no need to discard the competition playbook simply because platforms in the digital economy operate "online." Competition authorities have ample experience in applying competition enforcement tools to two-sided platform markets in an "offline" environment.[13] Newspapers, for instance, show that network effects in two-sided platform markets do not necessarily result in dominant positions and are not necessarily a cause for concern in themselves. Indeed, the presence of network effects has sometimes been found to contribute to "protecting" consumers from price increases, for example in the newspaper industry where the need to attract a large circulation for advertisers was found to constrain the potential for increases in cover prices.[14]

As to the sustainability of perceived market power, giants that, despite their size, are themselves not necessarily immune from being toppled over. MySpace and Bebo, if you remember them, serve as useful reminders of how short-lived perceived dominance can be.[15] If the digital markets in question are contestable, or if they are competed for at regular intervals, then market power held by online platforms is more likely to be transitory – and the opportunity to achieve interim rents may spur innovation.

D. Shifting Emphasis Of Regulation From Ex-Ante To Ex-Post

What if, despite all the difficulties in identifying a group of businesses that can be usefully categorized and treated as "online platforms", and challenges in identifying common and predictable patterns of harm, we nevertheless were to heed calls for economic regulation of digital platforms?

In terms of the timing of any intervention, three types of risk can be observed: (1) acting prematurely, (2) inadvertently ossifying evolving market structures, and (3) acting too late. In our view, the most significant risks arise from premature broad-brush ex-ante legislation or rule-making in markets that are still rapidly evolving.[16] Let's consider these risks and the policy implications flowing from them in more detail.

1. The Risk Of Acting Prematurely

The potential costs of ex-ante regulation should be carefully considered. Premature ex-ante regulation cannot only impose substantial direct compliance costs, but can also reduce potential competition. This is very topical in light of the ongoing efforts to optimize communications regulation.

Considering an example from outside of regulation: the European Court of Justice's ("ECJ") landmark "right to be forgotten" ruling of May 2014.[17] The ECJ found in the particular case that a person's right to data protection could not be justified merely by the economic interest of the search engine. Since then Google has processed over 300,000 requests relating to over a million URLs. Unlike Google, with all its financial strength can well afford the considerable additional resources needed to process all of these cases, many smaller companies and potential entrants would likely not be able to sustain these additional compliance costs, and may therefore be held back from mounting a competitive challenge.

Leaving aside costs of compliance, protecting consumers by virtue of ex-ante regulation is inherently difficult in digital markets where consumer preferences evolve fast and in a less predictable manner. It is, therefore, important not to be over-confident in identifying the preferences of consumers and deciding what is in their interest. For example, in the trade-off between security and convenience, most policy-makers and regulators would tend to place a strong emphasis on the former, wishing to protect consumers from fraud and privacy abuses. Consumers themselves, however, have consistently shown a strong preference for convenience. Sometimes just one less click has been enough to cause consumers to prefer one app over another, more secure app. The analogue world often offers a very imperfect guide to consumer preferences in digital markets that continue to evolve apace. As a consequence, even with the best intentions, the preferences that regulators ascribe to consumers at one point in time may not necessarily reflect those preferences that they hold or will hold in the future.[18]

2. The Risk Of Ossifying Evolving Market Structures Through Codification

If ex-ante regulation is applied too early it risks protecting early innovators from a following wave of more welfare-enhancing disruption caused by subsequent innovators. To put it another way, if the new digital giants — once innovative firms — get entrenched in their positions as a result of ex-ante regulation and do not face credible threats due to the higher barriers for new entrants, they will also tend to pass up opportunities to innovate and invest. Today's plucky innovators are tomorrow's sleepy incumbents who'll soon be calling for — or willingly succumbing to —regulation to protect their rents. Ex-ante regulation may, as a consequence, entrench the incumbent's position by imposing regulatory hurdles that the newcomers have to face.

Where ex-ante regulation is introduced, for instance by mandating greater compatibility between platforms, it risks harming innovation by locking in existing standards and discouraging or preventing more disruptive, "radical" innovations. The evolution of digital markets has been particularly difficult to predict. Recent changes include e-commerce morphing from auction-sites to more broadly embedded social media services; the rapid transformation of payment and communication systems; and a plethora of innovations in the incompletely-solved problem of search on mobile devices. But there's one innovation we haven't seen yet: the crystal ball informing us reliably of the impact of future innovations in digital markets. In its absence, we cannot know which ex ante interventions are free from the risk of inhibiting further welcome innovations.

The risks of getting it wrong show that we need a shift from broad-brush ex-ante regulation to ex-post antitrust enforcement, which is better adapted to responding to the rapidly changing innovative markets online platforms operate in. As Director-General Johannes Laitenburger has rightly pointed out, competition law focuses on "specific business practices" in digital markets. Ex-post tools have the inherent advantage of being more targeted and proportionate by examining the extent to which actual harm may have occurred based on empirical evidence on a case-by-case basis.

E. Evolving The Ex-Post Enforcement Toolkit: The Need To Adapt Our Practices

However, a shift from ex-ante regulation to ex-post enforcement requires competition authorities, policymakers, businesses and consumers alike to adapt their practices in a collective effort to ensure the challenges brought by online platforms are addressed effectively.

1. Competition Authorities

As competition authorities, we need to:

First, ensure we do not act too late. Investigations, even where litigated through the courts, should not take 10 years to complete, and arrive only when the market has changed beyond recognition. This means considering opportunities for expedited action, including interim measures to prevent harm arising while we investigate, as well as means to achieve earlier outcomes through commitments or settlements.

Second, acknowledge that there are certain, familiar antitrust concepts that may not take sufficient account of the nature of digital markets and so should not be transposed across to them without careful consideration. The "essential facility" doctrine, for instance, was developed in the context of infrastructure assets that are difficult to replicate. Concepts applying to ports cannot simply be copy-pasted into the digital world, or specifically to online platforms, where the potential source of market power is not generally derived from big infrastructure requirements and high fixed costs. Equally, an analysis that focuses on revenues can ignore the true nature of the economic value provided, where this lies in customer relationships or consumer data.[19]

Third, look for opportunities to test and design remedies at an early stage to ensure they work in the real world and in a cost-effective manner. Online business models tend to be flexible, constantly evolving business models and have an abundance of data that can help improve remedy design.

Fourth, provide better protection for commercial complainants. It is vital that complainants are not afraid to come to the competition authority for fear of retaliation from a dominant platform.

Fifth, we need more and earlier international joint working. We must exploit synergies in very similar cases that are simultaneously being taken across multiple jurisdictions. For a recent example, consider the family of cases brought by multiple E.U. competition authorities in relation to hotel online booking. We also need to try to avoid a patchwork of potentially inconsistent regulatory or enforcement approaches.

2. Policymakers And Regulators

There are also many useful steps that policymakers and regulators may wish to consider:

First, establish a minimum set of rights, including around privacy for consumers. Clear rules in such cases can avoid disputes and distrust. They also embed more fundamental rights, relating to citizenship, which do not lend themselves to ex post economic assessment in the way that questions of market power and commercial behavior do.

Second, set clear standards around data protection by businesses. The ECJ's recent ruling declaring the "safe harbor" data agreement invalid leaves many companies scrambling to overhaul their Internet operations with no effective regime. [20] Complex digital infrastructure decisions affecting thousands of businesses and millions of consumers should ideally not be left to judges.

Third, clarify responsibilities around consumer protection. The regulatory framework should ensure that online platforms provide clear information on how they operate,[21] and what their responsibilities are, so consumers can make informed choices. [22]

Fourth, ensure that market analysis is alive to the growing importance of content as a key differentiator, not only in the competitive battle between telecoms operators, fiber, cable and satellite companies, but increasingly as a key customer recruitment and retention tool for the internet-based digital platforms.

Fifth, seek out opportunities for removing obstacles to cross-border trade, particularly by standardizing regulatory requirements. The EC sector inquiry into e-commerce may provide opportunities here.

Finally, consider deregulation. If policy makers were to seek to avoid every hypothetical consumer harm through pre-emptive ex-ante regulation, they would likely prevent many best-case scenarios entailing significant consumer benefits from ever coming about.[23] Policymakers and regulators should be open to the idea that a review of existing regulation and its suitability in the context of online platforms may actually result in a withdrawal of such regulation - creating a reasonably level playing field by "leveling down" as opposed to "leveling up."

The benefits brought about by certain online platforms may provide good arguments for pursuing a deregulatory approach. For instance, they can expand the range of options and information available to consumers, by facilitating reputational feedback mechanisms, thereby potentially reducing the problem of asymmetric information between producers and consumers. This could lower or even remove the need for regulation, allowing more scope for market competition to fix problems.

This holds for all of the Digital Single Market agenda and the authors hope that both the European Commission and BEREC will keep this deregulatory opportunity firmly in mind in the review of the EC Electronic Communications framework.[24] The bar for introducing new forms of communications regulation — such as has been proposed to deal with oligopoly industry structures — must be a high one.[25]

3. Businesses

At the same time, businesses also need to play their part in ensuring ex-post enforcement works better than ex-ante regulation. In particular, they should:

First, improve the transparency of the information available on how they operate. The amount of public information about the workings of digital platforms is low. Is it any surprise, then, that these platforms continue to arouse suspicion? Also, being transparent in representing the options available, such as how to transfer data collected, to consumers who want to switch.

Second, take more responsibility for satisfying consumers that their legitimate concerns about privacy and data protection are being fully respected.

Thirdly, look for opportunities to grow by innovation. For example, much of the focus of our biggest telecoms operators has been on managing the cash-flows that sustain their debts acquired through spectrum purchases and M&A. A lot of attention has been given to pricing structures, consolidation and cost control, and regulatory bargaining, rather than break-through technologies and services.

4. Consumers

Last but not least, consumers will also need to continue adapting:

First, by being engaged and proactive. Consumers need to recognize the benefits of switching between platforms or search engines. Keeping providers on their toes can be a powerful tool we all have at our disposal as consumers. This also includes switching to a provider who is transparent and reassuring about the use of personal data — the "currency" consumers use to pay for apparently free services.

Second, by providing effective feedback. A recent petition in London relating to transport regulation is an interesting example of proactive consumer engagement: more than 130,000 people signed up within a matter of days. We need consumers to continue to help guide policy-makers, regulators and competition authorities on where they see their best interests.

III. CONCLUSION ON ANTITRUST LAW VERSUS SECTOR-SPECIFIC LEGISLATION

In summary, we do not face a binary choice between antitrust and sectorial regulation - instead they must complement each other. Competition authorities and communications regulators must work together to update and adapt our practice to tackle the challenges they face effectively. The costs of premature, unmeritorious interventions are likely to be very high, given the positive impact of welfare-enhancing innovations. A necessary shift towards the use of reinvigorated, ex-post tools will allow for more evidence-based, and therefore more targeted and proportionate, enforcement. The digital platforms should be judged and treated according to how they behave, and how this affects consumers.

1 Alex Chisholm is the Chief Executive Officer of the Competition and Markets Authority ("CMA") in the United Kingdom. Nelson Jung is the Director of the Mergers Group at the CMA. The CMA is the U.K.'s national competition agency, the successor body to the Office of Fair Trading and the Competition Commission. The authors are very grateful to a number of colleagues at the for their contribution to this article, in particular Paul Tregear, Robert Ryan, Tony Curzon Price, Mike Walker, Simon Constantine and Ida Sundstrom. The views expressed are personal to the authors and all errors, omissions, and opinions are their own. This article is an expanded version of a speech given by Alex Chisholm at the Bundesnetzagentur in Bonn in October 2015.

2 European Commission, "A Digital Single Market Strategy for Europe," communication from the commission to the European parliament, the council, the European economic and social committee and the committee of the regions, COM (2015) 192 final, Brussels, May 6, 2015, A Digital Single Market Strategy for Europe COM(2015)192 final.

3 European Commission, "Bringing down barriers in the Digital Single Market: No roaming charges as of June 2017" Strasbourg, October 27, 2015, http://europa.eu/rapid/press-release_IP-15-5927_en.htm; European Commission, "Roaming charges and open Internet: questions and answers," Brussels, June 30, 2015

http://europa.eu/rapid/press-release_MEMO-15-5275_en.htm; European Commission, "Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL laying down measures concerning the European single market for electronic communications and to achieve a Connected Continent, and amending Directives 2002/20/EC, 2002/21/EC and 2002/22/EC and Regulations (EC) No 1211/2009 and (EU) No 531/2012," COM (2013) 0627 final, September 3,2013,http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1447864542922&uri=CELEX:52013PC0627.

4 Any content provider has had the opportunity to test its ideas and their relative value in the marketplace. The required investment and therefore barriers to entry, for instance the costs associated with buying a domain name, renting a space on a server and implementing its application or software, have been relatively low. As a result, new services have been made available to consumers: browsing, mailing, Peer-to-Peer (P2P), instant messaging, Internet telephony (Voice over Internet Protocol "VoIP"), videoconference, gaming online, video streaming, etc. This development has taken place mainly on a commercial basis without any regulatory intervention.

5 However, even the strongest supporters of the net neutrality regime will admit that it will inhibit some business models, for example involving paid-for performance enhancement, from evolving, which may have been welfare-enhancing.

6 One of the first to use the expression 'platform neutrality' was the French National Digital Council (Conseil National du Numérique), which published a detailed report on this concept in June 2014, following an earlier request from the Ministry of the Economy and Digital Affairs as well as the Secretary of State on Digital Affairs See Conseil National du Numérique (2014), "Platform Neutrality: Building an open and sustainable digital environment," Opinion No. 2014-2, of the French Digital Council, Paris (www.cnnumerique.fr/wp-content/uploads/2014/06/PlatformNeutrality_VA.pdf). The French and German governments explicitly called on the European Commission to establish regulation for essential platforms, invoking neutrality as one of the attributes of such platforms' future conduct. *See* "Europe's demands on Google mount," *Financial Times*, November 26, 2014, www.ft.com/intl/cms/s/0/66b5149e-758a-11e4-b082-00144feabdc0.html#axzz3WpR2sSn7. The debate also surfaced in the United States

last year, when Blackberry CEO John Chen officially complained that Netflix had not made movies available for Blackberry phones, and invoking platform neutrality – or 'app neutrality' – as a much-needed remedy, Karl Bode, "No, 'App Neutrality' Is Not A Thing," *Net Neutrality*, February 13, 2015, www.techdirt.com/blog/netneutrality/articles/20150122/08093329777/no-app-neutrality-is-not-thing.shtml.

7 Andrea Renda, "Antitrust, Regulation and the Neutrality Trap: A plea for a smart, evidence-based Internet policy," *Centre for European Policy Studies,* no. 104 (2015). In rejecting the need for any such neutrality requirements, Renda suggests that the "European Commission seems to have been pervaded by a neutrality delirium."

8 Competition and Markets Authority, *The Economics of Open and Closed Systems*, December 16, 2014, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/387718/The_economics_of_open_and_closed_systems.pdf.

9 Competition and Markets Authority, *Payday Lending market investigation,* Final report published February 24, 2015, https://www.gov.uk/cma-cases/payday-lending-market-investigation.

10 Competition and Markets Authority , *Retail Banking market investigation,* November 6, 2014, https://www.gov.uk/cma-cases/review-of-banking-for-small-and-medium-sized-businesses-smes-in-the-uk

11 David Evans and Richard Schmalensee, "The Antitrust Analysis of Multi-sided Platforms," *National Bureau of Economic Research*, (2013). Evans & Schmalensee note that competition analysis of multi-sided platforms needs to take account of all of the sides of the platform and indirect network effects between them. Any analysis or policy rules that ignore this complexity are prone to commit serious errors.

12 For example the Commission is currently carrying out investigations into Google regarding alleged abuse of dominance. It is the Commission's preliminary view that Google is abusing a dominant position, in breach of European antitrust rules, by systematically favoring its own comparison shopping product in its general search results pages in the European Economic Area. The Commission is concerned that users do not necessarily see the most relevant results in response to queries, to the detriment of consumers and rival comparison shopping services, as well as stifling innovation. The Statement of Objections alleges that Google treats and has treated more favorably, in its general search results pages, Google's own comparison shopping service 'Google Shopping' and its predecessor service 'Google Product Search' compared to rival comparison shopping services (http://europa.eu/rapid/press-release_MEMO-15-4781_en.htm) . Google has responded to the Commission's Statement of Objections.

13 The competition implications of network effects in two-sided markets have been examined for some time. By way of example, Liebowitz and Margolis found that network effects and the tendency towards a natural monopoly in networked industries are often over-estimated, Stan J. Liebowitz and Stephen E. Margolis, "Network Externalities (effects)," in *The New Palgrave's Dictionary of Economics and the Law* (London: MacMillan Reference Limited, 1998).

14 *See* for instance the OFT's decision on the anticipated acquisition by Northcliffe Media Limited of Topper Newspapers Limited of 16 July 2012, where the presence of network effects in two-sided market was a contributing factor to a clearance decision, in particular paragraphs 126 and 127: "Were Northcliffe to raise the cover price of The Post, it is likely that its circulation would fall resulting in both its fixed costs having to be met by the remaining readers or by advertisers […] due to the presence of indirect network externalities, declining circulation would make it harder for Northcliffe to raise revenue from advertisers. As a result, Northcliffe would not have the ability or incentive to reduce profitably the output of this title."

15 Alex Chisholm, "Giants of digital: separating the signal from the noise and the sound from the fury" (CRA Competition Conference, Brussels,December 10, 2014); Justus Haucap and Ulrich Heimeshoff argue that it is not possible to generalize about competition in online markets and that there is insufficient evidence that Google's and Facebook's strong market positions will be long lasting, whereas eBay appears to have held a dominant position for over a decade: *see* Justus Haucap and Ulrich Heimeshoff, "Google, Facebook, Amazon, eBay: Is the internet driving competition or market monopolisation," *International Economics and Economic Policy 11,* (2013); *see* also the OECD paper on the digital economy roundtable (2012) which notes that certain market features militate against the appearance of tipping points in the digital economy, including diminishing returns to scale and congestion effects. The paper indicates that these features as well as low switching costs and per-transaction charges weaken the competition-suppressing network effects of cross-group externalities. As such, it argues that network effects have to be assessed on a case-by-case basis to determine their competitive implications, at http://www.oecd.org/daf/competition/The-Digital-Economy-2012.pdf.

16 Nicholas Economides commented that regulation carries high risks in industries characterized by highly innovative firms in "Antitrust Issues in Network Industries,"*The Reform of EC Competition Law* (2008).

17 Case-131/12, *Google Spain SL,Google Inc. v Agencia Española de Protección de Datos (AEPD),Mario Costeja González,* May 13, 2014,

18 For further discussion, Competition and Markets Authority, *The commercial use of consumer data: report on the CMA's call for information*, June 17, 2015.

19 This is illustrated by Google paying nearly $1bn for the crowd-sourced travel-mapping app Waze, which generated little revenue at the time. *See* the OFT's merger control decision of 11 November 2013 regarding the completed acquisition by Motorola Mobility Holding (Google, Inc.) of Waze Mobile Limited, ME/6167/13. Note that in turnover-based merger control the focus on revenues means that some potentially anticompetitive mergers could fall below the regulatory radar, whereas the United Kingdom is able to examine such transactions under its share of supply jurisdictional test. A further illustration is the EC investigation into the Facebook/WhatsApp merger, where the Commission analysed to what extent potential data concentration issues could hamper competition in the online advertising market. Case No COMP/M.7217, *FACEBOOK/ WHATSAPP,* 3 October 2014, http://ec.europa.eu/competition/mergers/cases/decisions/m7217_20141003_20310_3962132_EN.pdf.

20 *See* this month's ruling of the European Court of Justice regarding the transatlantic Safe Harbour agreement in Case C-362/14, *Maximillian Schrems v Data Protection Commissioner,6 October 2015, http://curia.europa.eu/juris/document/document.jsf?docid=169195&doclang=EN* , *see* also "Europe's costly judgment on data protection," *Financial Times*, 7 October 2015, http://www.ft.com/cms/s/0/7b5a672e-6d09-11e5-aca9-d87542bf8673.html#axzz3oAXtkI63.

21 For instance, the law requires consumers to be given "material" information (information they require to make an informed transactional decision). Failure to do so could be a misleading omission contrary to Regulation 6 of the Consumer Protection from Unfair Trading Regulations 2008.

22 The speed at which technology is changing - and the rapid emergence of novel online business models - present challenges to the appli-

cation of many existing and traditional regulatory frameworks. Issues relating to online platforms encompass not just competition law, but many other regulatory regimes, including intellectual property rights, taxation, employment, cybersecurity, consumer protection and data protection.

23 Adam Thierer, *Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom* (Virginia: Mercatus Center at George Mason University, 2014). Christopher Koopman, Matthew D. Mitchell, Adam D. Thierer, "The Sharing Economy and Consumer Protection Regulation: The Case for Policy Change," *The Journal of Business, Entrepreneurship & the Law* 8 (2014); MaryAnne M. Gobble, "Regulating Innovation in the New Economy," *Research-Technology Management* 58, no.2 (2015).

24 European Commission, "Public consultation on the evaluation and the review of the regulatory framework for electronic communications networks and services," September 11, 2015, https://ec.europa.eu/digital-agenda/en/news/public-consultation-evaluation-and-review-regulatory-framework-electronic-communications.

25 This refers to how a number of electronic communications markets have evolved so that only a small number of multi-functional operators are now competing, offering broadband, TV, fixed and mobile telephony packages, based on some combination of fibre, cable, copper and wireless networks. Some commentators have questioned whether new ex ante powers may be needed to deal with such concentrations. However, both economic literature and empirical observations show how oligopolistic competition can be effective – one reason why there is no presumption against this form of competition in the rest of the economy. BEREC's recent report on oligopoly analysis and regulation found that not all oligopolies raise competition issues and therefore oligopolies are not necessarily always problematic such that they require regulatory action, *see* http://berec.europa.eu/eng/document_register/subject_matter/berec/reports/5042-draft-berec-report-on-oligopoly-analysis-and-regulation. The report notes that oligopolistic market settings are only of concern when they contribute to a non-competitive market outcome, resulting in significant consumer harm/welfare loss, thus requiring regulatory action to address evident or potential market failures. In any event, in assessing the case for new regulation, we should not downplay the potential of existing competition tools to tackle such issues.

New business models and competition enforcement: must we ride the tide of change?

Bruno Lasserre [1]

I. INTRODUCTION

New business models seem all-pervasive today, with the result that older forms of trade feel under constant threat.

There is undoubtedly a surge in more intangible forms of innovation that rely on new ways of selling existing goods or services. Recent examples of exponential growth in revenues and market capitalization come for the most part from these firms which have rolled out new ways of providing an existing service or supplying an existing product: AirBnB, founded in 2008, is reportedly valued at $20 billion; Uber's value, created in 2009, is now estimated at $50 billion.

By blurring the line between traded services and non commercial "sharing" activities or by eroding taxable revenues in the country where the service is consumed, these new business models have, in several instances, raised policy concerns that touch on the capacity for a "sovereign" to effectively regulate and raise taxes on services being traded on its soil.

Sector-specific rules established to frame a given market activity and operators are also destabilized when new business models create new layers (e.g., platforms) not foreseen by the sector regulation or lead to the removal of the traditional subjects of the regulation.

The debate is somewhat different for competition law and policy. The risk of circumventing or evading the application of competition law is limited, as enforcers rely on effects to assert jurisdiction rather than on the place of establishment. While the ongoing debate on platform regulation in Europe has led certain stakeholders to call for an adaptation or revisiting of competition law provisions or principles, the initiative is for the most part geared towards the establishment of a specific set of rules, lying outside the scope of competition enforcement, and pursuing alternative objectives. However, potential disruptions caused by new business models necessarily feed into our substantive assessments and cannot be ignored.

Let me begin by exploring what the denomination "new business model" actually encompasses (I), before I look at the impact of these models, first on the assessment carried out under competition law (II), then on the laws and regulations crafted to regulate certain economic sectors (III).

II. I. HOW TO SPOT A NEW BUSINESS MODEL

There are several features common to most successful new business models.

Firstly, as already underlined, new business models do not rely so much on product innovation as they do on innovative ways of combining or redefining existing techniques, products and services. Internet is often the springboard for such innovation, whether car-hire services, house rentals, film distribution or ride-sharing, to name a few and now familiar "digitalized" services.

Secondly, the aim is to "revolutionize the economic structure from within…destroying the old one, creating a new one," as aptly described by Joseph Schumpeter: the firm seeks to displace incumbents, on its own terms.

Thirdly, disruptive new business models are driven by charismatic, highly visible entrepreneurs whose success relies on (i) a new idea; (ii) a first mover advantage; (iii) a capacity to shore up capital and investment at the nascent stage of their activity, on the promise of high future returns.

Fourthly, the innovation brought about is radical rather than incremental or gradual in nature. Insiders did not see it coming and its very force is related to its unpredictable character.

Fifthly, new business models are the result of careful monitoring of demand to spot general or niche dissatisfaction: Uber thrived on individuals' frustration with local taxi services; Blablacar — a France-based "unicorn" offering a ride-sharing platform service — tapped an existing, unaddressed demand for cheap, long-distance domestic transport.

Finally, new models often favor strategies that allow them to circumvent barriers to entry and expansion. This is in particular the case with firms acting as intermediaries, such as Uber or AirBnB, which can limit upfront costs associated with developing a vehicle/chauffeur fleet or building and managing a hotel, by relying on "independent" providers. The franchising model is premised to some extent on the same logic but it is taken here at another level: it is not only entrepreneurs who are affiliated but individuals renting out their house or providing part-time car-hire services with their own car.

Adopting a broad-brush approach to the issues raised for competition by new business models, one can distinguish between two relevant subsets.

If the new business model is in fact a platform, whose function is to put in relation different users or users with professionals, effects likely to accrue are those more broadly associated with digital platforms: direct and indirect network effects, self-reinforcing and prone to snowballing into a "winner takes all" situation; a tendency towards conglomeral or vertical integration with a view to building an entire ecosystem.

If the new business model is a low cost model, such as that of Easyjet or Ryanair in the airline industry, we may be attentive, for instance, to the ability, for a new entrant, to replicate the cost structure of the first low cost carriers in order to compete effectively. Overtime, for precursors of the low cost model reaping the benefits of first mover advantage and consolidating their customer base and market share, regulatory barriers may turn from an obstacle to an advantage if they limit the opportunities of potential low cost alternatives.

III. II. WHICH CHANGES, IF ANY, DO NEW BUSINESS MODELS BRING TO THE APPLICATION OF COMPETITION LAW?

Competition law enforcement operates on a case-by-case basis, adjusting to market evolutions and revisiting, where necessary, precedents. The approach taken is both static and dynamic, thereby excluding the assumption on the part of agencies that the current state of play is the only relevant reference point.

The advent or prospect of new business models thus feeds into our analysis and is duly taken into account before adjudicating on a matter, whether for purposes of antitrust enforcement or merger control. This notwithstanding, agencies must also tread cautiously, for fear of giving too much weight to a phenomenon which, while a possible game-changer, does not necessarily imply that solidly grounded findings reached in the past no longer hold true for our relevant time horizon.

For instance, with respect to market definition, because of the primacy of demand-side substitution in the delimitation of the relevant market, new business models really have a bearing on market definition only once they result in significant and lasting changes in demand and consumer patterns.

One example is the market for "multiple play" bundles, which includes three or more of the following services: fixed telephony services, mobile services, fixed Internet access services and TV services. These bundles reflect the commercial convergence at work between mobile and fixed services, but also between content and network, on the back of the "despecialization" of telecom infrastructures that can carry voice and heavy data services, both at home and on the go via mobile phone. Agencies currently have the choice between upholding the existence of a separate "multiple play" services market, which either co-exists with or absorbs current unbundled markets, or to deal with "multiple play" services directly within their competitive assessment, in particular when looking at the conglomeral effects of a merger. For the time being, neither the French Autorité (*Numericable/SFR,* 2014) nor the European Commission (*Liberty Global/Ziggo*, 2014) have gone so far as to uphold a distinct "multiple play" services market, an evolution that ultimately depends on the rate of multiple-play bundle take-up in a given geographic market and the resilience of distinct unbundled offerings.

Another example relates to the rise of subscription-based video-on-demand (SVoD) services offered by so-called "over the top" ("OTT") providers, such as Netflix. In the context of merger reviews involving pay-TV providers, parties to the transaction often argue that these new non-linear services are in direct competition with linear pay-TV services and accordingly belong to the same market, or alternately exercise strong competitive pressure that mitigates the risk of horizontal and vertical effects. However, these claims have, to date, been rebutted by competition agencies, including in France (*Canal +/TPS,* 2012), in light of the nascent character of SVoD services, their limited take-up or the difference in quality and lack of premium content. Interestingly, these decisions reflect the truth that incremental changes, such as those brought about by the development of non-linear services, do not instantly remove the competitive concerns attached to the exercise of market power in the more "traditional" segments. Indeed, the flurry of channels, distributors and broadcasting technologies has not put an end to concerns that may arise with respect to the concentration of buyer power for certain broadcasting rights in the hands of a few pay TV behemoths. Concerns thus remain, if only during a transitional period.

Yet another example are digital music streaming services, which present technological specificities that are distinct from digital music download, but that can also be looked at as a new business model (subscriber-based rather than pay per download). They were envisaged as a separate segment in the Commission's *Universal/EMI* (2012) case but ultimately brought together with download services within a single relevant market, in light inter alia of the "competitive interaction" between the two segments.

Once the relevant market is delineated, the question is then the relevance of market shares. Either a new model is a market in and of itself, with the result that the innovator holds ipso facto a dominant or monopoly position. Alternatively, it is subsumed within a larger differentiated market; the specificity of the new model must then be accounted for. As regards to low cost models that rely on a strategy of aggressive pricing, they can be seen as holding a special role in animating competition: accordingly, the effects of a takeover by a competitor of such a market player will tend to be scrutinized carefully. Agencies will look beyond prima facie limited market shares to ascertain the impact on competitive interactions.

As regards antitrust enforcement, the appraisal of potentially anticompetitive behavior in relation to a new business model is probably more fraught, at least in its nascent stages.

The Autorité thus adopted a decision in 2004 rejecting VirginMega's claim to access Apple's proprietary digital rights management system ("DRM"), Fairplay, to allow for the direct transfer of music downloaded from Virgin's platform onto an iPod. The rejection was based on the nascent character at the time of the market for the sale of digital music and the fact that Apple's DRM could not be said to constitute a facility essential to the development of a music platform. Holding otherwise would have led the Autorité to anticipate on whether the market would evolve into silo-like competition or not, a conjecture it could not make on the basis of the evidence adduced to it during the investigation and at the time it adjudicated on the case.

However, if and when they become prominent, there is a temptation for firms that prospered through a breakthrough to foreclose access to the market by future potential innovators. The example of online travel agencies ("OTA") is a case in point. The price parity clauses that they imposed on their hotel clients had the effect of freezing price-competition between OTAs to the detriment of new entrant OTAs that did not benefit from the notoriety, scale and scope of incumbents and could mostly rely on price differentiation as a tool to gain access to the market — a tool made ineffective by virtue of the price-parity clauses. The Autorité addressed these parity clauses jointly with its Italian and Swedish colleagues and in close coordination with the European Commission. This led to commitment decisions being adopted vis-à-vis Booking.com on the same day, April 21, 2015, in the three countries. The arrangement provides a satisfactory balance since it makes it possible to improve competition between platforms and consequently promote a reduction in the fees applied to hotels. It further reassigns a counterbalancing power to hotels by perceptibly improving their commercial and pricing freedom while preserving the efficiency gains that the platforms' economic model has permitted.

Moreover, competition law serves to curtail strategies by incumbents to prevent, in the first place, the entry on the market of offers built around a new business model. This can be illustrated by a decision of 2014 in which the Autorité considered that the practice implemented by the publishing group Amaury of closing off the market to a new entrant (Le 10Sport.com) in order to reinforce the monopoly of its newspaper (L'Équipe) constituted an abuse of dominance, and imposed as a consequence a fine of EUR 3.5 million against the group. Amaury launched on the same day as Le 10Sport.com the daily news Aujourd'hui Sport, which was of the same format and targeted the same audience as Le 10Sport.com. After a few weeks of operation, due to poor financial results, Le 10Sport.com ceased its publication, which was then released on a weekly basis.

The Autorité established the exclusionary practice on the basis of a number of factual elements: the clear intention to drive the new entrant out of the market (as evidenced by documents seized during dawn raids), the lack of economic rationality of the implemented strategy (that implied a financial sacrifice and was suboptimal compared to other response scenarios, but inflicted the most damage to the competitor), the launch of a similar competing newspaper on the same day, the purposely limited lifetime of the newly created newspaper conceived as pure retaliation to the imminent threat of the new entrant, and the exit of Le 10Sport.com from the market as a consequence of the drying-up of its readership base.

Another related issue concerns the strategy pursued by certain firms to systematically buy out potentially innovative rivals, whether innovation is already materialized through a recently launched product or service or has yet to materialize (pipeline products). These situations can be looked at and are addressed by competition agencies in the context of a merger review. More generally, the wide-spread adoption of the Significant Impediment to Effective Competition/Substantial Lessening of Competition ("SIEC/SLC") test in merger control can be credited for stimulating an effects-based approach and a careful analysis, on a case-by-case basis, of the incentives and ability of merging parties to increase prices notwithstanding the absence of dominance and depending on the dynamics of the specific market at hand.

However, the monitoring, by agencies, of these strategies of systematic acquisition may sometimes stumble upon jurisdictional thresholds not necessarily attuned to the economic reality of high potential/low turnover targets. The *Facebook /Whatsapp* case (2014) is to some extent a case in point: with Whatsapp valued at $22 billion but achieving a global turnover of around $15 million, turnover thresholds alone were not able to capture this transaction, which nonetheless raised competition concerns exceeding many transactions which do fall under the purview of competition agencies. Ultimately, the case was referred to the European Commission by the British Competition and Markets Authority, the latter asserting jurisdiction on the basis of market share thresholds. Drawing from this experience, the German Monopolkommission suggested in early June 2015 applying a size of transaction threshold to capture transactions involving start-ups with no or limited revenue at the time they are bought out. The proper design of jurisdictional thresholds is of course complex and requires a careful balance between legal certainty for stakeholders, the avoidance of excessive administrative burdens, the need for a sufficient local nexus and the effective monitoring and remedying of undesirable outcomes for competition. The debate remains however open as to the need to adjust current rules, in order to ensure preemptive acquisitions do not become, in the future, the tool of choice to circumvent merger control.

IV. III. DO NEW BUSINESS MODELS REQUIRE NEW REGULATIONS?

The emergence of new business models oftentimes calls into question the existing legal environment, either with a view to enable these new models to reach their full potential or, conversely, to erect hurdles with the aim of protecting incumbents.

Competition agencies routinely deal, in the context of their advocacy work, with the review of draft or existing regulations, to identify possible constraints on competition and examine the justifications brought forward by decision-makers for these constraints, in light of their necessity and proportionality.

Competitive constraints may become apparent only once the new business model has been rolled out and the inadequacy of rules fashioned for traditional models is thereby revealed.

For instance, E.U. rules paved the way in 2013 for the opening up of online sales of non-prescription medicine in France. However, national obligations weighing on chemists, irrespective of the sales channel used (e.g., brick and mortar or online), have the effect of stifling the development of online sales and prevent professionals from making the most of the cost savings and increase in bargaining position expected from a pick-up in web-based sales. Such a situation requires proactive steps to revise regulations and enable market players to fully benefit from the new opportunities conferred on them by this market opening. Regulatory changes are thus instrumental in bringing about positive market outcomes resulting from the emergence of new business models.

Unfortunately, new regulations do not always seek to create an enabling environment but rather strive to protect incumbents by tightening conditions for market access and activity. This is a reflection of the sway "insiders" hold over policy-makers, by emphasizing immediate threats on their activity and employees and contrasting these with the more diffuse benefits of innovation, spread through millions of consumers and users. The case of Uber in France is a telling example of the implementation of protective regulations that aim in practice to extend taxis' de jure monopoly on street-hailed car-hire services to services provided with a prior booking. The Autorité sought, in three successive opinions issued in 2013, 2014 and 2015, to distinguish legitimate regulatory intervention aimed at stepping-up the training and insurance obligations of Uber-type services from intervention that artificially impedes their activity (15-minute lapse between booking and passenger pick-up; obligation for the driver to return to its "base" once the passenger reaches its destination). The Autorité also suggested leveling the playing field for taxis by allowing them to charge fixed-rates rather than metered rates, in order to adapt their pricing to consumer demand. These opinions exemplify the Autorité's approach, which seeks to promote a healthy, competition-inducing environment, in the interests of all actors, whether new or traditional.

Beyond tweaking regulations to address the challenges posed by new business models, certain stakeholders put forward reform proposals that seek to cover a wider array of actors, defined precisely by the model they rely on, namely the provision of "platform" services. It is beyond the scope of this contribution to provide a comprehensive and definitive view on this issue, which is still being debated and whose scope and objectives are, to date, still uncertain. A provisional conclusion can nonetheless be drawn from the above considerations, which is that strong economic assumptions cannot be made per one broad category of actors, defined loosely as "new business models" or even as "platforms." The implications for competition of the emergence of such actors depend heavily on the markets concerned and their specific features as well as on the impugned behavior. Competition law, with its universal remit, plastic legal concepts and case-by-case approach, provides a satisfactory basis on which to construct principles of economic regulation that preserve the incentives to innovate while mitigating the risks of market preemption.

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Uber and the Rule of Law: Should Spontaneous Liberalization Be Applauded or Criticized?

By Damien Geradin [1]

ABSTRACT

While Uber is able to operate legally in a growing number of countries and cities, regulatory approval has proved to be elusive in other jurisdictions. Yet, in a number of regions or cities Uber decided to launch its services despite the absence of regulatory approval. The fact that Uber has decided to engage in "spontaneous liberalisation" has drawn criticism from various quarters. But should Uber be blamed for failing to comply with certain regulatory requirements or should they be applauded for pushing the boundaries of the law? Whether spontaneous liberalization should be applauded or criticized depends. While there is generally no justification for ignoring rules that are necessary to protect the services' users and nonusers from the risks that are inherent to the carrying of passengers on public roads, there is an element of public good in testing the boundaries of public restrictions of competition. Whatever happens to Uber's efforts to challenge rules impeding its ability to deliver certain categories of services in certain markets, the taxi industry has already changed for the better as many taxi companies have developed their own apps, either alone or with others, and have made efforts to improve their quality of service. Uber was a needed electroshock in an industry whose actors had often become complacent and failed to meet user expectations.

I. INTRODUCTION

There is hardly a day without a front page story in the Financial Times or the Wall Street Journal about Uber and its struggles with transportation authorities on the four corners of the world. These struggles are often due to the fact that Uber does not fit into the legal regimes that regulate traditional taxi services. The taxi industry is heavily regulated and the rules in place create barriers to entry by, for instance, limiting the number of taxis that are allowed to operate in a given city.[2] Price regulation may also sit uneasily with a business model where prices may vary based on a variety of factors, including not only distance and time, but also the availability of vehicles at a given time of the day.[3]

Uber and other online platforms have also triggered massive protest from taxi companies and their drivers as they see Uber as a threat to their viability.[4] They claim that Uber engages in "unfair competition" by failing to comply with the regulatory requirements that burden traditional taxi companies, and in several jurisdictions taxi companies and associations have launched proceedings seeking to have Uber's activities declared illegal.[5] More generally, trade unions and left leaning politicians are hostile to what they see as the *Uberization* of the economy as (allegedly) good, well-paying jobs are destroyed and replaced by precarious occupations.[6] Of course, these views are a caricature of the reality, but there is no doubt that Uber has triggered a fair amount of hostility in some of the markets it has tried to enter into.

On the other hand, consumers love Uber and it is not hard to see why. Uber rides are materially cheaper than taxi rides[7] and quality of service tends to be higher.[8] Consumers also love the ability of booking a vehicle through their smartphone and see the car progressing towards their location without worrying as to whether it will eventually show up. Users also have the possibility to rate their drivers, hence giving them incentives to be polite and drive safely.[9] Finally, there is no need to carry cash as payments are done electronically, and the driver will not expect you to give him a tip (which materially increases the cost in some countries). As Ben Edelman and I observed elsewhere, online platforms, such as Uber, are a source of considerable efficiencies, including reduction of transaction costs, improved allocation of resources, as well as information and pricing efficiencies.[10]

Although Uber has drawn a lot of attention, it is not the first time that fossilized markets are disrupted by new entrants. The last three decades have witnessed waves of liberalization in Europe in markets ranging from telecommunications to air transport services.[11] Yet, liberalization in these industries was structured with markets being opened in stages following the adoption of EU legislation.[12] What is new with Uber, but also with online platforms like Airbnb, is that these companies did not necessarily wait for regulatory approval before launching their services. While Uber was able to obtain a license in many cities in the United States and abroad, such licenses proved very hard to obtain in some jurisdictions for a variety of reasons. Yet, Uber often decided to go ahead with the success we know. From a legal standpoint, this raises interesting questions. Should we applaud Uber for having the guts to start its operations in the absence of regulatory approval? Or should we instead be appalled by what could be perceived as a form of contempt for the law? There are no simpler answers to these questions, which this paper is seeking to address.

This paper is divided in six sections. Section II explains that the taxi industry has been regulated for a long time, but passengers are not necessarily impressed by the quality of service they obtain. Section III explains why Uber has been willing and able to launch its services in various cities and regions without necessarily obtaining prior regulatory approval. Section IV addresses the issue of whether Uber should be applauded or criticized for engaging in spontaneous liberalization. Section V explains the role that regulatory authorities and competition authorities can play in the liberalization of the taxi industry. Finally, Section V concludes.

II. BASIC SERVICE, HEAVY REGULATION, UNHAPPY CUSTOMERS

Taxi services are quite basic in nature. Taxis move people from point A to point B against the payment of a fee. Taxis are typically driven by low-skilled workers (although some of them have an extraordinary knowledge of the city in which they operate) and in most cities, there is nothing fancy about the service. Yet, the taxi industry is regulated to a surprising extent. As we have seen, in many cities, the number of licensed taxis is strictly limited and fares are regulated. Taxi regulations are rather lengthy and detailed, and include some requirements that do make sense and others that do not.

Taxi regulations have a long history. For instance, the regulation of the taxi industry in the United States largely came in reaction to the "ruinous competition" that took place during the great depression where too many cars were chasing too few passengers.[13] Thus, caps were placed on the number of licenses and these caps were not necessarily relaxed over time despite demographic and economic growth. For instance, in New York, there were 13,437 licensed taxis in 2014, a number of licenses that is smaller than when caps were introduced by the Haas Ordinance in 1937.[14] Other rules aim to address market failures, such as externalities (accidents caused by drivers), information asymmetries (that can result in price gouging), cognitive biases (leading to insufficient attention to risks), and public goods (undersupply of wheelchair accessible vehicles).[15]

Of course, businesses that are subject to regulation like to complain about the burden it imposes on their activities. But they may also like regulation when it creates barriers to entry and immunize them from competition.

The problem is that industries that are protected by barriers to entry tends to fossilize and the taxi industry is no exception. A striking feature of the taxi industry is the lack of innovation. Some may say that it is hard to innovate when your service consists in moving passengers from point A to point B, but it is not entirely true. Technology can be used to make the service more efficient, hence the spectacular development of Uber and other online platforms. New services like car-pooling can also be introduced and various initiatives can be taken to improve the user experience.

It is therefore unsurprising that Uber quickly conquered a large customer base. Yet, Uber also faces major regulatory challenges. First, it is not easy to launch a service, however novel and attractive, when the number of authorized vehicles is strictly capped with a secondary market for licenses trading at inflated prices.[16] Second, as will be further discussed below, the regulatory framework applying to the taxi industry is extraordinarily fragmented with almost every region or city having its own rules and authorities of control. Thus, unlike in many areas, penetrating the market is a region by region or city by city struggle, which may last for months or even years. Third, taxi rules were adopted with a certain business model in mind at a time where the Internet, let alone online platforms did not exist. Taxi rules also developed as a result of political compromises to allow some degree of competition between different types of services, such as for instance regular taxi services and limousine services. Yet, Uber's service does not easily fit into any of the existing categories. Finally, the taxi industry is well organized and is able to exert significant pressure on regulatory authorities. Even with a lot of good will, obtaining an authorization to launch services is by no means an easy task even where there is significant unmet demand.

III. ENTERING THE MARKET WITH OR WITHOUT REGULATORY APPROVAL

While Uber is able to operate legally in a growing number of countries and cities,[17] regulatory approval proved to be elusive in other jurisdictions. However, in a certain number of regions or cities Uber decided to launch its services despite the absence of regulatory approval. The reasons why Uber has adopted this strategy are most likely multi-fold.

First, it is questionable whether Uber's services should be assimilated to traditional taxi, or more generally, transportation services, considering that Uber is essentially a marketplace connecting occasional private drivers offering rides and passengers seeking a ride through a software application. In other words, given the nature of its services it is not clear that Uber should be subject to the regulatory frameworks, including license requirements, which are applied to taxi or other categories of transportation services. This issue of the nature of Uber's services is not of academic interest only as it will soon be analysed by the European Court of Justice ("ECJ") following requests for preliminary rulings respectively made by Spanish and Belgian courts.[18]

Second, if one assumes for the time being that Uber is a transportation service, this means Uber needs to obtain the go ahead from many regulators since, as we have seen above, the regulatory framework is extremely fragmented. Unlike most regulated firms (telecommunications service providers, pharmaceutical companies, etc.), which are generally controlled by one regulatory authority per country, Uber needs to obtain regulatory approval from dozens of regulators located at the regional or even city level. This renders the regulatory approval process hopelessly complex and time-consuming, hence creating incentives for launching the service in as many cities as possible even if this means facing some prohibitions.

Third, it is easy to overestimate the difficulty of successfully launching a two-sided platform.[19] The challenge is to draw users from both sides (in this case drivers and prospective passengers) at the same time and in the right proportions. There is no point drawing hundreds of drivers to the platform if they are too few prospective passengers and vice-versa. Moreover, to be sustainable, the platform needs to gain scale as quickly as possible.[20] There is thus some urgency in launching an online platform and growing it rapidly. With this aim in mind, it is unsurprising that Uber is willing to launch its services in some cities without regulatory approval (or with approval pending) even if this creates a risk of having to discontinue the services following a court order.

Fourth, unlike in many industries, Uber's business model is not characterized by large sunk costs besides the development of the platform. Thus, the cost for Uber of terminating its operations in a given location is not prohibitive since it does not have to lay-off drivers or roll back any type of infrastructure. The financial risk of launching a service before obtaining regulatory approval is thus limited. By contrast, it would not be wise for a power producer to build a power station or for a telecommunications operator to lay wires into the ground before obtaining regulatory approval as a subsequent failure to obtain such an approval would have very severe financial consequences. That is one of the reasons why spontaneous liberalization has not been observed in these industries with some limited exceptions.

Finally, Uber is betting on the fact that its users will put pressure on the regulators to grant the regulatory approval it needs. While taxi companies and their drivers have a fair amount of political weight, Uber users, although less organised, may also have a word to say. Once users have learned to enjoy the efficiencies generated by Uber (in terms of booking convenience, quality of service and lower costs), they will certainly not want the service to be discontinued due to a lack of regulatory approval. For instance, when Uber had to discontinue its uberPop service in Brussels following an adverse court decision, thousands of regular users signed an online petition calling "on the Government to reform today's outdated legislation now!"[21]

IV. SPONTANEOUS LIBERALIZATION: SHOULD UBER BE APPLAUDED OR CRITICIZED?

The fact that Uber has decided to engage in spontaneous liberalisation has drawn criticism from various quarters. But should Uber be blamed for failing to comply with certain regulatory requirements or should they be applauded for pushing the boundaries of the law?

There is not a single answer to that question as the taxi industry is subject to a variety of regulatory constraints. First, as already noted, certain requirements aim at controlling entry into the sector. Cities may, for instance, limit the number of taxis that are allowed to operate legally, hence often creating a scarcity of cars at certain times of the day. Second, regulatory requirements may be designed to address market failures. That is the case of rules of safety and insurance requirements, as well as the need, for instance, to provide for wheelchair accessible vehicles. Without State intervention, the market may provide an insufficient degree of consumer protection or the services offered would not be socially inclusive. Finally, taxi companies, like all other companies, are subject to "horizontal" legislation, such as for instance labor and tax requirements. While variations may apply across sectors, core labor or tax principles generally apply across the board.

While it seems difficult to justify, let alone encourage, breaches by Uber or other platforms of the second and third category of regulations, it is submitted that, in certain circumstances, there may be merits in ignoring rules that create barriers to entry and restrictions of competition (whatever their rationale may be), provided however that unsuccessful efforts were made to obtain regulatory approval in the first place. Throughout modern economic history, new entrants took the risk of penetrating markets subject to regulatory barriers to entry. In some cases, the rules may be unclear and their exact scope needed to be judicially defined. But in other cases, companies launched services that breached statutory monopolies or other forms of public restrictions on competition at the risk of facing serious brushes with the law.[22]

In this respect, the E.U. case law is replete with examples of companies penetrating markets subject to exclusive rights and other restrictions of competition.[23] In some cases, their actions eventually led to the opening of large chunks of the economy. Let us take the example of Mr. Corbeau, a small entrepreneur who was subject to criminal proceedings for delivering value-added "postal" services, whereby personal collection would be made from the sender's premises and delivery made before the next day in the same area. While these services were in breach of the Belgian postal monopoly, Mr. Corbeau's lawyers eventually convinced the ECJ that the postal incumbent's exclusive rights over the services it performed were in breach of E.U. law.[24] The judgment of the ECJ, in turn, played a major role in the liberalization of the postal sector.[25]

Thus, while nobody would want online platforms to operate services that are unsafe and put users and the general public at risk, breaching questionable restrictions of competition may sometimes be needed to upset the status quo. In this respect, whatever happens to Uber's efforts to challenge rules impeding its ability to deliver certain categories of services in certain markets,[26] the taxi industry has already changed for the better. For instance, many taxi companies have developed their own apps, either alone or with others, and have made efforts to improve their quality of service.[27] Uber was a needed electroshock in an industry whose actors had often become complacent and failed to meet user expectations.

V. THE ROLE OF THE PUBLIC AUTHORITIES

While public authorities are under pressure from both Uber and the taxi industry, their role should be to allow Uber to operate on the market so that consumers can benefit from their efficiencies, while maintaining the regulatory requirements needed to ensure the correction of market failures.

This requires the following tasks.

First, regulators should determine whether online platforms connecting private drivers with passengers should be subject to the same (type of) regulatory frameworks as taxi companies, which operate their own vehicles and employ some of their drivers. This is a complex issue, which will not be discussed in this short essay, but that has become particularly relevant in the context of the preliminary rulings referred to above. The solution may be to create specific frameworks for online platforms that take into account the characteristics of the services provided and ensure that these services are provided safely and in a socially-inclusive manner.

Second, regulators should revisit rules creating barriers to entry, such as caps on the number of vehicles that are allowed to operate on the market. The regulator should investigate whether the reasons that historically prevailed to establishing a cap on the number of licensed vehicles (e.g., vast oversupply) still hold and, if they do, whether the objectives sought can be achieved by less restrictive alternatives. Second, if it is determined that the number of licensed vehicles need to be capped, a doubtful proposition, it should be determined whether the number of licensed vehicles is set at an optimal level (not for taxi companies, but to satisfy consumer needs) and whether licenses should be available for regular taxis only or extended to online platform operators.

Third, regulators should review the regulatory framework to make sure that the rules that seek to address market failures effectively accomplish their goals. For instance, background checks on drivers and regular inspection of vehicles are certainly desirable, but with increased competition, it is questionable whether taxi fares should still be subject to regulation. Rate regulation may still be needed for taxi that are hailed on the street, but for vehicles that are e-hailed, price regulation no longer seems justified as users usually have the ability to request a fee estimate and thus to be informed of the expected cost of their planned journey.[28] It also seems that the ability to rate drivers may also go a long way towards protecting users against reckless driving or abusive behaviour, probably more so that rules allowing passengers to file complaints to the regulator when problems occur.[29] Given the new possibilities offered by technological advances, it is certainly a good time to revisit regulatory frameworks, which may have been developed a long time ago.

Fourth, as decades-old regulatory frameworks cannot, and in many cases should not, be overhauled in a day, it is important to ensure a transition. In this respect, when regulatory approval cannot immediately be granted, there are advantages in granting temporary licenses to online platforms. First, this allows users not to have to wait for many months to benefit from the efficiencies that are generated by these platforms. Moreover, much can be learned from the data that is generated by the operation of online platforms. In a sector where data is critical,[30] it will generally be wise for regulators to take market data into account when revisiting their existing regulatory framework. Such data may, for instance, be used to see whether Uber better serves areas that are traditionally underserved or whether allowing Uber vehicles to operate creates additional congestion.

Fifth, regulators may need to compensate taxi drivers or operators for the losses they may have incurred as a result of allowing Uber and other platforms to operate. Difficult situations may arise when drivers have invested large sums of money in the acquisition of a license, which they intend to resell at some stage as part of their retirement plan.[31] While granting compensation may not always be justified (e.g., when licenses have been used as speculative instruments) or may be a source of additional difficulties,[32] it seems important to at least reflect on ways to ease the pain of the transition to a more competitive market.[33]

Finally, to the extent that regulators decide the revisit the existing regulatory frameworks, it is important to adopt rules that are technology neutral and flexible enough to accommodate further innovation. With driverless cars around the corner, the industry is likely to continue to evolve, possibly in a much more spectacular manner that what has been witnessed so far.

While regulators may be willing to modernize the regulatory framework, their work may be impeded by the activities of interested groups, which may threaten to carry out strikes and use their political connections to impede the work of reform-minded authorities. While these efforts are to be expected, there seems to be no valid reason to shelter the taxi industry from competition and to prevent users from enjoying new, innovative services.

Competition authorities also have an important role to play through competition advocacy.[34] It is an important part of their mission to ensure that public authorities do not adopt or maintain regulatory frameworks that restrict competition. As to the European Commission, it has been at the forefront of the liberalization process in network industries using competition rules to put an end to regulatory measures impeding market access. There is, for instance, a highly developed case law analysing and often striking down, on the basis of Article 106 of the Treaty of Functioning of the European Union ("TFEU") combined with other Treaty provisions, a variety of public measures restricting competition.[35] While taxi services are local in nature, the use of online platforms gives a cross-border dimension to their activities.

VI. CONCLUSION

The taxi industry has witnessed a process of spontaneous liberalization with Uber and other platforms delivering services even in the absence of regulatory approval. Various factors explain why this strategy would not have been possible in sectors characterized by heavy sunk costs. Liberalization in these sectors thus pursues a structured process with the market progressively opening to competition while eventually reaching full liberalization.

Whether spontaneous liberalization should be applauded or criticized depends. While there is generally no justification for ignoring rules that are necessary to protect the services' users and nonusers from the risks that are inherent to the carrying of passengers on public roads, there is an element of public good in testing the boundaries of public restrictions of competition. Uber's market entry has generated various legal actions in E.U. Member States, which notably through preliminary ruling procedure, will clarify the legal framework in which Uber can operate, with hopefully more space for competition and consumer choice than under the current regulatory frameworks.

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2 For instance, the number of licensed vehicles in the Brussels Region was set at 1,300 in 2003 and has not changed since then despite the growth of the city. See Arrêté du Gouvernement de la Région de Bruxelles-Capitale of 4 Septembre 2003 fixant le nombre de véhicules pour lesquels des autorisations d'exploiter un service de taxis peuvent être délivrées sur le territoire de la Région de Bruxelles-Capitale, available at http://www.gtl-taxi.be/3_28_549_3236_FR_Nombre_max_de_taxis_.

3 During periods when available cars are scarce (e.g., Friday and Saturday nights), Uber can incentivize drivers to take the road by increasing their fees (a process referred to as "dynamic" or "surge" pricing). Prices increase will at same time increase supply as drivers will be incentivized to take the road to earn higher fees, but also reduce demand as price-sensitive users are incentivized to consider alternatives, such as take their car or public means of transport. Cory Kendrick Hall and Chris Nosko,"The Effects of Uber's Surge Pricing: A Case Study," (2015), available at www.faculty.chicagobooth.edu/chris.nosko/research/effects_of_uber's_surge_pricing.pdf.

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10 Benjamin G. Edelman and Damien Geradin, "Efficiencies and Regulatory Shortcuts: How Should We Regulate Companies like Airbnb and Uber?," Working Paper No. 16-026 (Harvard Business School NOM Unit, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2658603.

11 Damien Geradin, The Liberalization of State Monopolies in the European Union and Beyond, (Kluwer Law International, 1999).

12 In the energy, postal services and telecommunications sectors, it took an average of ten years and several EU liberalization directives to move from monopoly to fully liberalized markets. This was necessary to make the liberalization process politically feasible, as well as to give incumbents time to adapt to competitive constraints.

13 For an historical perspective, see Paul Stephen Dempsey, "Taxi Industry Regulation, Deregulation & Reregulation: The Paradox of Market Failure", Transportation Law Journal 24, (1996): 73.

14 Lawrence Van Gelder, "Medallion Limits Stem From the 30's", New York Times, May 11, 1996, www.nytimes.com/1996/05/11/nyregion/medallion-limits-stem-from-the-30-s.html; Michael R. Bloomberg and David Yassky, Taxicab Fact Book, (2014), www.nyc.gov/html/tlc/downloads/pdf/2014_taxicab_fact_book.pdf.

15 See Edelman and Geradin, supra note 10.

16 Where licenses may have initially have been owned by drivers, they are regularly traded by individuals or companies, which see them as a profitable investments. The price of licenses has increased over the years to, for instance, exceed $1 million in New York. See Michael M. Grynbaum, "2 Taxi Medallions Sell for $1 Million Each", City Room, October 20, 2011, http://cityroom.blogs.nytimes.com/2011/10/20/2-taxi-medallions-sell-for-1-million-each/?r=0 Uber's entry has, however, depressed the price of licenses with taxi medallion owners deciding to sue New York City and its Taxi and Limousine Commission for allowing Uber into the market. See Joe Mullin, "Cab medallion owners sue NYC, blame Uber for ruining business", Ars Technica, November 18, 2015, http://arstechnica.com/tech-policy/2015/11/cab-medallion-owners-sue-nyc-blame-uber-for-ruining-business/.

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19 On two-sided platforms, see David. S. Evans and Richard Schmalensee, "The Industrial Organization of Markets with Two-Sided Platforms," Competition Policy International 3, no.1 (2007): 151.

20 David S Evans and Richard Schmalensee, "Failure to Launch: Critical Mass in Platform Businesses," Review of Network Economics 9, no.4 (2010).

21 This petition appears on Uber's smartphone screen when unsuccessfully trying to order a car.

22 For instance, Tesla did not hesitate to bypass the American franchised car dealer system in breach of state law prohibiting car manufacturers from operating their own dealerships. See Daniel A. Crane, "Tesla and the Car Dealers' Lobby," Regulation, (2014): 10. Damien A. Crane, "Tesla, Dealer Franchise Laws, and the Politics of Crony Capitalism," forthcoming Iowa Law Review (2015).

23 See, e.g., C-41/90, Höfner v. Macrotron, April 23,1991, ECR I-1979 (1991) (challenge of the exclusive rights of the Federal Office for Employment to put prospective employees and employers in contact with one another); C-260/89, ERT v. EDP, June 18, 1991, ECR I-2925 (1991) (challenge of ERT's exclusive rights to broadcasting and retransmitting television programmes in Greece); C-179/90, Merci Convenzionali Porto di Genvo v. Siderurgica Gabrielli SpA, December 10, 1991, ECR I-5889 (1991) (challenge of a company's exclusive right to organize the loading, unloading and other handling of goods within the Port of Genova); C-553/12 P, July 17,2014, European Commission

v. DEI, ECR I-0000 (2014) (challenged of the Greek state-owned electricity company DEI's exclusive right to mine for lignite (brown coal)).

24 C-320/91, Corbeau, May 19, 1993, ECR I-2533 (1993).

25 Damien Geradin and Christophe Humpe, "The Liberalisation of Postal Services in the European Union," Kluwer Law International in The Liberalisation of Postal Services in the European Union: An Analysis of Directive 97/67, ed. Damien Geradin (The Liberalisation of Postal Services in the European Union, 2002), 91.

26 Duncan Robinson, "Germany faces European Commission probe over Uber ban", Financial Times, July 14, 2015, www.ft.com/intl/cms/s/0/d522e39e-2a47-11e5-8613-e7aedbb7bdb7.html#axzz3rx2P13sP.

27 For instance, G7, which is the largest taxi company in France, has launched in own app, see http://www.taxisg7.com/order-taxi/taxi-from-smartphone.

28 Uber provides online fee estimates for journeys planned by its users, see http://uberestimate.com/.

29 Some have, however, expressed concerns about the possible consequences of rating systems. See, Alex Hern, "Are Uber's passenger ratings big data for good – or discrimination 2.0?," The Guardian, July 28, 2015, www.theguardian.com/technology/2014/jul/28/are-ubers-passenger-ratings-big-data.

30 Vehicle-data may, for instance, provide valuable information to regulators on issues, such as consumer demand at various times of the day, traffic flows and congestion, etc. For instance, the Taxi and Limousine Commission (TLC) of the City of New York collects data on taxi cabs rides. See www.nyc.gov/html/tlc/html/about/trip_record_data.shtml.

31 Sam Harnett, "For San Francisco Cab Drivers, Once-Treasured Medallions Now a Burden," KQED News, 24 September 24, 2015, http://ww2.kqed.org/news/2015/09/24/for-san-francisco-cab-drivers-once-treasured-medallions-now-a-burden.

32 For a strong criticism of compensation regimes, see Edmund W. Kitch, "Can We Buy Our Way Out of Harmful Regulation?," Deregulating American Industry: Legal and Economic Problems, ed. Martin & Schwartz (Lexing books, 1977).

33 For an excellent discussion of the ways in which transition to more competitive markets can be addressed, see Michael J. Trebilcock, Dealing with Losers – The Political Economy of Policy Transitions (Oxford: Oxford University Press, 2014).

34 See International Competition Network, Advocacy and Competition Policy, Report prepared by the Advocacy Working Group ICN's Conference Naples, Italy, 2002, www.internationalcompetitionnetwork.org/uploads/library/doc358.pdf.

35 See the cases listed supra note 23. See also Jose Luis Buendia Sierra, State Intervention and EU Competition Law, Exclusive Rights and State Monopolies under EC Law, (Oxford: Oxford University Press, 2000).

Whither Uber?: Competitive Dynamics in Transportation Networks

Benjamin Edelman[1]

ABSTRACT

Transportation Network Companies offer notable service advances—but do they comply with the law? I offer evidence of some important shortfalls, then consider how the legal system might appropriately respond. Though it is tempting to forgive many violations in light of the companies' benefits, I offer a cautionary assessment. For one, I note the incentives that might result, including a race-to-the-bottom as a series of companies forego all manner of requirements. Furthermore, the firms that best compete in such an environment are likely to be those that build a corporate culture of ignoring laws, a diagnosis that finds support in numerous controversial Uber practices. On the whole, I suggest evenhanded enforcement of applicable laws, with thoughtful changes implemented with appropriate formality, but no automatic free pass for the platforms that have recently framed laws and regulations as suggestions rather than requirements.

Suppose Acme Widgets manufactured cheaper widgets by dumping toxic widget byproducts in the river behind its factory. By foregoing the anti-pollution efforts that competitors use and that, to be sure, the law requires, Acme would gain a cost advantage over its peers. Unaware of Acme's methods, consumers would favor its products, and its market share would predictably surge. But few would celebrate this outcome—pollution that ultimately harms everyone, requiring cleanup at the public's expense.

In the transportation sector, there are reasonable arguments that Uber, Lyft, and kin (collectively, transportation network companies or TNCs) have chosen a similar approach. To be sure the companies offer important technical and business model innovations, which I discuss momentarily. But in cutting corners on issues from insurance to inspections to background checks, they push costs from their customers to the general public—while also delivering a service that plausibly falls short of generally-applicable requirements duly established by law and, sometimes, by their own marketing promises. Despite excitement about the benefits they provide, it is far from clear that the companies have chosen the right approach.

I. THE BENEFITS OF APP-BASED TRANSPORTATION NETWORKS

Even the staunchest critics concede that TNCs bring important efficiencies to the markets they serve. Consider, for example, the task of assigning drivers to passengers. Historic telephone-based dispatch of traditional drivers today seems laughably inefficient. When a customer calls a dispatcher who then alerts drivers by radio, the sequential oral communications are quite literally a "game of telephone" with inevitable errors. But errors are only the tip of the iceberg. At best, a dispatcher could find the closest available driver. But dispatchers have limited information about driver availability and locations, and might end up matching a passenger with a far-away driver, thereby delaying the driver's arrival to the customer and simultaneously increasing the driver's unpaid "backhaul" with no passenger aboard. At least as worrisome is that dispatchers have been accused of demanding kickbacks for referring desirable passengers such as those headed to an airport—further distorting matching of passengers and drivers. TNCs remedy these mishaps by replacing phone calls with text entries and GPS, simultaneously eliminating dispatcher cost, delay, errors, and potential bias. It is shrewd, efficient, and by all indications highly effective. The TNC approach also dispenses with proprietary taximeters, often surprisingly pricey, in favor of standardized mass-produced smartphones drivers can also use for other purposes.

In addition, TNCs add important levels of accountability for both drivers and passengers. Most passengers have had the experience of waiting for a driver who never comes. That could be an error, perhaps the result of double-dictation of a passenger's location. But consider a driver who is driving, unpaid, to a passenger pickup—only to see a roadside hail right along the way. With no further unpaid driving required, the hail will often be too good to refuse—even if it leaves the telephone booking unsatisfied. Meanwhile, if the passenger happens to see an available taxi, he too has every incentive to hop in—even if that's not the vehicle the dispatcher sent. Each party may regret shortchanging the other. But anticipating that the other may in turn shortchange him, they're likely to do so anyway. TNCs fix this too, in part with real-time tracking of vehicle location (so a passenger can see the vehicle en route), plus accountability through reputations (penalties on both sides for no-shows) and as well as payment linked to traveling in the assigned vehicle.

Though controversial, the TNC approach to pricing also seems to reflect a step forward. There is no logical reason why urban transportation prices must be the same price at all times of day. To the contrary, if prices reflect both supply and demand, flexible passengers will shift journeys to off-peak times, and price spikes will inspire drivers to provide service at peak times. Of course there are losses, most notably to the lucky passengers who previously obtained vehicles at peak times at no additional charge. But if those benefits were previously assigned randomly, greater surplus is created through optimal matching of passengers to vehicles based on willingness to pay. In principle, TNCs on net should be able to make all customers better off, including through lower prices at off-peak times. All of this would be virtually impossible in an offline context—too difficult for passengers and drivers to identify the appropriate price in light of available information about changing conditions, plus inevitable disputes at the end of a journey. But in a mobile app, electronic contracting and automatic record-keeping make this easy.

Still other efficiencies come from the prospect of using a single vehicle for multiple purposes. It is tragic to see a taxi driver drive a personal vehicle to a depot to pick up a taxi—contributing to congestion and pollution along the way, yet failing to transport any passengers; wasting time on a drive with no direct benefit to anyone; and parking, buying, and maintaining two separate vehicles, only one of which is used at a time. TNCs handily eliminate these sources of waste by reusing the driver's personal vehicle, albeit simultaneously raising the problems discussed in the subsequent sections.

Ultimately, the TNC electronic dispatch model facilitates numerous further efficiencies. In developing countries, jitneys have long provided multi-passenger hop-on-hop-off service, often a fixed price to travel as far as you want on a single main road or route. Despite low prices, jitneys tend to have limited appeal; consider an origin or destination off the preset route. In contrast, TNCs can facilitate on-demand multi-passenger routing, including limited detours for pick-ups and drop-offs so long as inconvenience to others falls within the given parameters. Centralized algorithms and routing are crucial for these improvements; such flexibility would be difficult or impossible without strong IT support. Meanwhile, TNC drivers can also transport packages, restaurant meals, and almost anything else—perhaps even in spare time when passenger demand is light. One wonders about the distinctive benefits of purpose-specific vehicles, but perhaps efficiencies from shared usage can outweigh any capabilities not available. To its credit, TNCs stand ready to try.

II. CUTTING CORNERS AND WORSE

While the widespread adoption of TNCs plainly results in part from the innovations just discussed, their growth also follows their use of what we might call "regulatory shortcuts" – less than strict compliance with applicable rules.

A first potential concern is that TNC drivers lack medallions or taxi permits. Many cities require such permission to accept roadside hails, and in major cities, buying a medallion entails considerable expense. That said, the TNC approach seems not to require a medallion: In most jurisdictions, the defining characteristic of a taxi is permission to accept an ad hoc roadside hail, whereas TNC passengers request rides via a mobile app, making this "prearranged" transportation rather than "taxi" as a matter of law. This one, at least, TNCs seem to get right—a clever hack to escape a regulatory scheme that TNCs (and many passengers) consider ill-advised.

But what about the myriad other requirements the legal system imposes on commercial drivers? Consider: In most jurisdictions, a "for hire" livery driver needs a commercial driver's license, a background check and criminal records check, and a vehicle with commercial plates, which often means a more detailed and/or more frequent inspection. Using ordinary drivers in noncommercial vehicles, TNCs skip most of these requirements, and where they take such steps (such as some efforts towards a background check), they do importantly less than what is required for other commercial drivers (as discussed further below). One might reasonably ask whether the standard commercial requirements in fact increase safety or advance other important policy objectives. On one hand, detailed and frequent vehicle inspections seem bound to help, and seem reasonable for vehicles in more frequent use. TNCs typically counter that such requirements are unduly burdensome, especially for casual drivers who may provide just a few hours of commercial activity per month. Nonetheless, applicable legal rules offer no "de minimis" exception and little support for TNCs' position.

Differing standards for background checks raise similar questions. TNCs typically use standard commercial background check services that suffer from predictable weaknesses. For one, TNC verifications are predicated on a prospective driver submitting his correct name and verification details, but drivers with poor records have every incentive to use a friend's information. Online instructions tell drivers how to do it.[2] In contrast, other commercial drivers are typically subject to fingerprint verification. Furthermore, TNC verifications typically only check for recent violations--a technique far less comprehensive than the law allows. For example, Uber admits checking only convictions within the last seven years,[3] which the company claims is the maximum duration permitted by law. But federal law has no such limitation, and California law allows reporting of any crime for which *release or parole* was at most seven years earlier.[4] In *People of the State of California v. Uber*, these concerns were revealed to be more than speculative, including 25 different Uber drivers who passed Uber's verifications but would have failed the more comprehensive checks permitted by law.[5]

Relatedly, TNC representations to consumers at best gloss over potential risks, but in some areas appear to misstate what the company does and what assurances it can provide. For example, Uber claimed its service offered "best in class safety and accountability" and "the safest rides on the road" which "far exceed… what's expected of taxis"—but taxis, with fingerprint verification of driver identity, offer improved assurances that the person being verified is the same person whose information is checked. Moreover, Uber has claimed to be "working diligently to ensure we're doing everything we can to make Uber the safest experience on the road" at the same time that the company lobbies against legislation requiring greater verifications and higher safety standards.

A separate set of concerns comes from insurance. For one, TNCs encourage drivers to carry personal insurance rather than commercial insurance, anticipating, no doubt correctly, that drivers might be put off by the higher cost of commercial coverage.[6] But TNC drivers are likely to have more frequent and more costly accidents than ordinary drivers: they drive more often, longer distances, with passengers, in unfamiliar locations, primarily in congested areas and while using mobile apps. To the extent that drivers make claims on their personal insurance, they distort the market in two different ways: first, they push up premiums for other drivers. Second, the cost of their TNC accidents are not borne by TNC customers; by pushing the cost to drivers in general, TNCs appear to be cheaper than they really are.

In a notable twist, certain TNC policies not only encourage drivers to make claims on their personal policies, but further encourage drivers to commit insurance fraud. Consider a driver who has an accident during the so-called "period 1" in which the driver is running a TNC app, but no passenger has yet requested a ride from the driver. If the driver gets into an accident in this period, TNCs historically would deny both liability and collision coverage, claiming the driver was not yet providing service through the TNC. An affected driver might instead claim from his personal insurance, but if the driver admits that he was acting as a TNC driver—he had left home only to provide TNC services; he had transported several passengers already; he was planning more—the insurer will deny his claim. In fact, in all likelihood, an insurer in that situation would drop the driver's coverage, and the driver would also be unable to get replacement coverage since any new insurer would learn the reason for the drop. As a practical matter, the driver's only choices are to forego insurance coverage (a possibility in case of a collision claim, though more difficult after injuring others or damaging others' property) or, more likely, lie to his insurance issuer. California law AB 2293, effective July 1, 2015, ended this problem as to collision claims in that state, requiring TNCs to provide liability coverage during period 1, but offering nothing elsewhere, nor any assistance on collision claims.

Passengers with disabilities offer additional complaints about TNCs. Under the Americans with Disabilities Act (ADA) and many state laws, passengers with disabilities are broadly entitled to use transportation services, and passengers cannot be denied transport on the basis of disability. Yet myriad disabled passengers report being denied transport by TNCs. Blind passengers traveling with guide dogs repeatedly report that TNC drivers sometimes reject them. In litigation, Uber argued that its service falls beyond the scope of the ADA and thus need not serve passengers with disabilities, an argument that a federal court promptly rejected.[7] Nonetheless, as of November 2015, Uber's "Drivers" page continues to tell drivers they can "choose who you pick up,"[8] with no mention of ADA obligations, nor of prohibitions on discrimination on the basis of race, gender, or other prohibited factors.

For these reasons and others, numerous regulators have concluded that Uber cannot operate within their jurisdictions. But such findings are not self-effectuating, even when backed up with cease and desist letters, notices of violation, or the like. In fact, Uber's standard response to such notices is to continue operation. Pennsylvania Public Utility Commission ("PUC") prosecutor Michael Swindler summarized his surprise at Uber's approach: "In my two-plus decades in practice, I have never seen this level of blatant defiance," noting that Uber continued to operate despite an unambiguous cease-and-desist order.[9] Pennsylvania Administrative Law Judges were convinced, in November 2015 imposing $49 million of civil penalties including "the maximum penalty" because Uber flouted a prior PUC cease-and-desist order in a "deliberate and calculated" "business decision."[10] Nor was this defiance limited to Pennsylvania. Uber similarly continued to provide service at San Francisco International Airport, and affirmatively told passengers "you can request" an Uber at SFO, even after signing a 2013 agreement with the California Public Utilities Commission disallowing transport onto airport property unless the airport granted permission and even after San Francisco International Airport served Uber with a cease-and-desist letter noting the lack of such permission.[11] In some instances, cities ultimately force Uber to cease or suspend operations. But experience in Paris is instructive. There, Uber continued operation despite a series of judicial and police interventions. Only the arrest of two Uber executives compelled the company to suspend its casual driving service in Paris.

III. COMPETITIVE DYNAMICS UNDER INCOMPLETE ENFORCEMENT

Looking at TNC operations, it is striking to see the incompleteness of regulation or, more precisely, enforcement.

> **In this environment, competition reflects unusual incentives: Rather than competing on lawful activities permitted under the applicable regulatory environment, TNC operators compete in part to defy the law—to provide a service that, to be sure, passengers want to receive and buyers want to provide, notwithstanding the legal requirements to the contrary.**

The brief history of TNCs is instructive. Though Uber today leads the casual driving platforms, it was competing transportation platform Lyft that first invited drivers to provide transportation through their personal vehicles. Initially, Uber only provided service via black cars that were properly licensed, insured, and permitted for that purpose. In an April 2013 posting by CEO Travis Kalanick, Uber summarized the situation, effectively recognizing that competitors' casual drivers are largely unlawful, calling competitors' approach "quite aggressive" and "non-licensed."[12]

Suppose, as Travis's post indicates and as subsequent regulatory disputes seem to confirm, that casual driving services are and have been largely unlawful. Uber leaders clearly believe that such services are, on the whole, desirable and should be permitted, and any survey of consumers would likely agree. Assuming strict compliance with the law, how might Uber have tried to get its service off the ground? One possibility: Uber could have sought some jurisdiction willing to let the company demonstrate its approach. Consider a municipality with little taxi service or deeply unsatisfactory service, where regulators and legislators would be so desperate for the improvements Uber promised that they would be willing to amend laws to match Uber's request. Uber need not have sought permanent permission; with great confidence in its offering, even a temporary waiver might have sufficed, as Uber would have anticipated the change becoming permanent once its model took off. Perhaps Uber's service would have been a huge hit—inspiring other cities to copy the regulatory changes to attract Uber. Indeed, Uber could have flipped the story to make municipalities *want* its offering, just as cities today vie for Google Fiber and, indeed, make far-reaching commitments to attract that service.

Different as this may be from Uber's actual strategy, it is far from unprecedented. In fact, it is probably the right strategy, and maybe the only strategy, if a company concludes that breaking the law is highly likely to provoke substantial penalties. Consider the experience of Southwest Airlines as it planned early low-fare operations in 1967. Southwest leaders realized that the comprehensive regulatory scheme, imposed by the federal Civil Aeronautics Board, required unduly high prices, while simultaneously limiting routes and service in ways that, in Southwest's view, harmed consumers. Envisioning a world of low-fare transport, Southwest sought to serve routes and schedules CAB would never approve, at prices well below what regulation required. Had Southwest simply begun its desired service at its desired price, it would have faced immediate company-ending sanctions; though CAB's rules were increasingly seen as overbearing and ill-advised, CAB would not have allowed an airline to brazenly defy the law. Instead, Southwest managers had to find a way to square its approach with CAB rules—and, to the company's credit, they were able to do so. In particular, by providing solely intra-state transport within Texas, Southwest was not subject to CAB rules, letting the company serve whatever routes it chose, at the prices it thought best. Moreover, these advantages predictably lasted beyond the impending end of regulation: After honing its operations in the intra-state Texas market, Southwest was well positioned for future expansion.

Southwest's strategy was compelled by fear of regulators—knowing that breaching legal duties would guarantee severe penalties. But as Uber CEO Kalanick looked at Lyft in his revealing 2013 post, we see no such fear. Kalanick explains: Regulators "have chosen not to" bring enforcement actions "against non-licensed transportation providers," yielding "one-sided competition" to competitors' advantage and Uber's disadvantage. Uber laid out regulators' weakness: "Regulators for the most part will be unable to act or enforce in time to stop them before they have a critical mass of consumer support." Of course Uber might have moved to assist regulators, for example in gathering and organizing information about competitors' infractions, by proposing model regulations to adjust requirements in the way Uber considered wise, and by explaining the need for diligent enforcement to maintain fair competition. Uber could even have sued competitors whose methods competed unfairly—unlawfully!—with Uber's offering. Predictably, Uber did none of those things.

Uber's ultimate decision, to recognize Lyft's approach as unlawful but nonetheless to follow that same approach, is hard to praise on either substantive or procedural grounds. On substance, it ignores the important externalities discussed above—including safety concerns that sometimes culminate in grave physical injury and, indeed, death. On procedure, it defies the democratic process, ignoring the authority of democratic institutions to impose the will of the majority.[13] Uber has all but styled itself as a modern Rosa Parks defying unjust laws for everyone's benefit. But Uber challenges purely commercial regulation of business activity, a context where civil disobedience is less likely to resonate. And in a world where anyone dissatisfied with a law can simply ignore it, who is to say that Uber is on the side of the angels? One might equally remember former Arkansas governor Orville Faubus' 1957 refusal to desegregate public schools despite a court order.

Notably, Uber's approach puts other transportation platforms in a position that is at least as untenable. Consider Hailo's 2013-2014 attempt to provide taxi-dispatch service in New York City. On paper, Hailo had every advantage: $100 million of funding from A-list investors, a strong track record in the United Kingdom, licensed and insured vehicles, and full compliance with every applicable law and regulation. But Uber's "casual driver" model offered a perpetual cost advantage, and in October 2014 Hailo abandoned the U.S. market. Uber's lesson to Hailo: Complying with the law is bad business if your competitor doesn't have to. Facing Uber's assault in numerous markets in Southeast Asia, transportation app GrabTaxi abandoned its roots providing only lawful commercial vehicles, and began "GrabCar" with casual drivers whose legality is disputed. One can hardly blame them—the alternative is Hailo-style irrelevance. When Uber ignores applicable laws and regulators stand by the wayside, competitors are effectively compelled to follow.

Relatedly, when the competitive environment rewards law breaking, the victor may struggle to comply both with applicable law and with social norms. Notice Uber's recent scandals: Threatening to hire researchers to "dig up dirt" on reporters who were critical of the company.[14] A "God view" that let Uber staff see any rider's activity at any time without a bona fide purpose.[15] Analyzing passengers' rides to and from unfamiliar overnight locations to chronicle and tabulate one-night-stands.[16] Charging passengers a "Logan Massport Surcharge & Toll" for a journey where no such fee was paid, or was even required.[17] A promotion promising service by scantily-clad female drivers.[18] The CEO bragging about his business success yielding frequent sexual exploits.[19] "Knowing and intentional" "obstructive" "recalcitrance" in its "blatant," "egregious," "defiant refusal" to produce documents and records when so ordered by administrative law judges.[20] On one view, these are the unfortunate mishaps of a fast-growing company. But arguably it's actually something more than that. Rare is the company that can pull off Uber's strategy—fighting regulators and regulation in scores of markets in parallel, flouting decades of regulation and managing to push past so many legal impediments. Any company attempting this strategy necessarily establishes a corporate culture grounded in a certain disdain for the law. Perhaps some laws are ill-advised and should be revisited. But it may be unrealistic to expect a company to train employees to recognize which laws should be ignored versus which must be followed. Once a company establishes a corporate culture premised on ignoring the law, its employees may feel empowered to ignore many or most laws, not just the (perhaps) outdated laws genuinely impeding its launch. That is the beast we create when we admit a corporate culture grounded in, to put it generously, regulatory arbitrage.

IV. LOOKING BACK AND LOOKING AHEAD

Take a walk down memory lane for a game of "name that company." At an entrepreneurial California startup, modern electronic communication systems brought speed and cost savings to a sector that had been slow to adopt new technology. Consumers quickly embraced the company's new approach, particularly thanks to a major price advantage compared to incumbents' offerings, as well as higher quality service, faster service, and the avoidance of unwanted impediments and frictions. Incumbents complained that the entrant cut corners and didn't comply with applicable legal requirements. The entrant knew about the problems but wanted to proceed at full speed in order to serve as many customers as possible, as quickly as possible, both to expand the market and to defend against potential competition. When challenged, the entrant styled its behavior as "sharing" and said this was the new world order.

You might think I'm talking about Uber, and indeed these statements all apply squarely to Uber. But the statements fit just as well with Napster, the "music sharing" service that, during brief operation from 1999 to 2001, transformed the music business like nothing before or since. And we must not understate the benefits Napster brought: It offered convenient music with no need to drive to the record store, a celestial jukebox unconstrained by retail inventory, track-by-track choice unencumbered by any requirement to buy the rest of the album, and mobile-friendly MP3's without slow "ripping" from a CD.

Ultimately, Napster faced major copyright litigation, culminating in an injunction compelling the company to cease operations. Napster then entered Chapter 7 bankruptcy, and investors got nothing. One might worry that Napster's demise could set society back a decade in technological progress. But subsequent offerings quickly found legal ways to implement Napster's advances. Consider iTunes, Amazon Music, and Spotify, among so many others.

In fact, the main impact of Napster's cessation was to clear the way for *legal* competitors—to increase the likelihood that consumers might pay a negotiated price for music rather than take it for free. When Napster offered easy free music with a major price advantage from foregoing payments to rights-holders, no competitor had a chance. Only the end of Napster let legitimate services take hold.

And what of Napster's investors? We all now benefit from the company's innovations, yet investors got nothing for the risk they took. But perhaps that's the right result: Napster's major innovations were arguably insufficient to outweigh the obvious and intentional illegalities.

Uber CEO Travis Kalanick knows the Napster story all too well. Beginning in 1998, he ran Scour, a file-sharing service soon sued by the Motion Pictures Association of America and Record Industry Association of America on claims of copyright infringement. Scour entered bankruptcy in response, giving Travis a first-hand view of the impact of flouting the law. Uber today has its share of fans, including many who would never have dared to run Napster. Yet the parallels are deep.

It is inconceivable that the taxis of 2025 will look like taxis of 2005. Uber has capably demonstrated the benefits of electronic dispatch and electronic record-keeping, and society would be crazy to reject these valuable innovations. But Uber's efforts do not guarantee the $50+ billion valuation the company now anticipates—and indeed, the company's aggressive methods seem to create massive liability for intentional violations in most jurisdictions where Uber operates. If applicable regulators, competitors, and consumers succeed in litigation efforts, they could well bankrupt Uber, arguably rightly so. But as with Napster's indisputable effect on the music industry, Uber's core contributions are unstoppable and irreversible. Consumers in the coming decades will no more telephone a taxi dispatcher than buy a $16.99 compact disc at Tower Records. And that much is surely for the best.

1 Benjamin Edelman is an associate professor at Harvard Business School. His research and writings are at www.benedelman.org

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Competition Policy in Consumer Financial Services: The Disparate Regulation of Online Marketplace Lenders and Banks

Thomas P. Brown and Molly E. Swartz [1]

INTRODUCTION

In October 2014, Washington D.C. City Council passed legislation that effectively allowed Uber to operate in the District. David Plouffe, formerly an advisor to the President and now an executive with Uber, greeted the new legislation with the following observation:

> **Obviously what we're doing doesn't necessarily in all cases fit in existing regulation. I think that's what Washington really wrestled with and decided they needed to chart a new pathway forward. So rather than say how do we fit this new technology and service into existing regulations, let's look at how do we create new regulations that give citizens of the city the right kind of confidence on things like safety, on things like insurance.**[2]

Uber is just one of many startups struggling to fit their businesses into existing regulatory frameworks. As technological innovation leads to new business models, there is increasing friction between these new companies and the existing regulatory regime.

The tension between regulated entities and new entrants is particularly acute in the context of online marketplace lending.[3] While bank lenders enjoy regulatory privileges that enable them to lend immediately to consumers in all 50 states, non-bank lenders are forced to engage in resource-intensive analyses to satisfy state-specific compliance requirements. As non-bank lenders expand access to credit to those currently underserved by banks—providing new underwriting methodologies, real-time data transmission and new financing mechanisms—disparate regulation of banks and non-bank lenders appears problematic.

In the past, where new entrants have challenged existing regulatory frameworks, restructuring has occurred to ensure a functioning market.

This continues to happen in a number of industries, with the Uber-led transformation of taxi regulation being the most prominent. This kind of regulatory reorganization is also needed in the lending space. The existing framework for regulating the delivery of financial services works against the interests of consumers, competition, regulators and society as a whole. A state-by-state legal regime serves as barrier to entry protecting incumbent banks from competition and depriving consumers of alternatives. There is simply no reason why banks should enjoy access to the common market while non-bank lenders cannot.

This is not to say that banks and non-banks should be treated similarly on all counts. There are numerous situations in which it is appropriate for banks to maintain regulatory privileges inaccessible to non-banks. In fact, in the context of financial services, banks tend to bear a greater regulatory burden than non-banks (e.g., application of customer identification program requirements, required maintenance of leverage ratios, etc.). In the lending context, however, banks' unique ability to offer products on a nationwide basis remains largely unjustified.

In Part I below, we provide an overview of online marketplace lending. We suggest that marketplace lenders offer value that is not currently replicable by banks. Part II examines marketplace lending across state lines, recognizing the near impossibility of full compliance. Part III provides examples of cases in which new entrants have successfully challenged existing regulatory frameworks. In these cases, regulatory change reinvigorated competition to the benefit of consumers. Finally, in Part IV, we suggest the need for reorganization of the existing lending regulatory framework. The current bifurcated regulatory framework increases costs to consumers, limits consumer choice and insulates banks from competition.

I. ONLINE MARKETPLACE LENDING BENEFITS BOTH UNDERSERVED BORROWERS AND INVESTORS

In the past few years, marketplace lending has emerged as an alternative to traditional bank lending. In the wake of the 2008-2009 financial crisis, banks tightened credit guidelines. This left many consumers and small businesses without access to bank-issued credit. Total consumer lending fell by 6.1 percent between January 2009 and March 2010.[4] At the same time that they tightened credit standards, banks found themselves a safe haven for deposits even as yields on those deposits plummeted.

The simultaneous tightening of credit standards and drop in yields created an opportunity for new credit intermediaries to emerge. Marketplace lenders filled this gap. In their initial incarnation, firms such as Prosper and Lending Club enabled lenders to fund loans to borrowers. They and other alternative lenders simultaneously expanded the pool of available credit and enabled yield-starved investors to obtain a positive rate of return on funds that would have generated no return had they been left on deposit at banks and other depository institutions.

Marketplace lenders differ from traditional financial institutions in a number of ways. First, marketplace lenders often serve demographics that are underserved by bank lenders. Marketplace lenders have enabled "thin file" borrowers and small business borrowers to access credit that traditional financial institutions were unwilling to extend. Borrowers rendered ineligible by traditional bank underwriting models may find investors on online marketplaces willing to finance their credit needs. Alternative underwriting models may enable such lenders to extend credit to thin file borrowers who would not qualify for credit based solely on traditional underwriting criteria such as FICO score.

Second, marketplace lenders rely on technology to reduce the cost of connecting borrowers with lenders. They use algorithms, rather than lending officers, to screen borrowers, and they provide granular information about repayment risk to investors. Further, many such platforms have eliminated unnecessary or unwanted services associated with traditional lenders, such as branches and other physical locations.5 Through better underwriting and more efficient operations, marketplace lenders and other lending platforms have lowered the cost of obtaining loans and are able to offer borrowers credit on better terms.

Third, platform lenders offer value to investors. Marketplace lenders have enabled investors to diversify their investment portfolios by investing directly in individual loans. Even to the extent that investors choose to fund pools of loans rather than individual loans, marketplaces may be able to pass a larger portion of the interest that those loans generate to the investors that fund their loans.6

II. MARKETPLACE LENDING ACROSS STATE LINES TRIGGERS SIGNIFICANT COMPLIANCE OBLIGATIONS

In lending across state lines, marketplace lenders, like other non-bank lenders and, indeed, all non-bank providers of financial services, confront a complex, unstable and fragmented regulatory regime. The regulatory thicket that surrounds the financial services industry in the United States, particularly the lending business, is Byzantine. A firm that is considering launching a product that provides liquidity to customers must grapple with a long list of Federal laws and regulations, including the Truth-in-Lending Act,7 the Fair Credit Reporting Act,8 the Electronic Funds Transfer Act,9 the Equal Credit Opportunity Act,10 Regulation Z,11 and Regulation E12 (to name but a few). Individual states have their own laws. California, for example, regulates non-bank lenders through the California Constitution,13 the Finance Lenders Law14 and, in some instances, the Consumer Legal Remedies Act.15

How and whether any one of these laws or regulations applies turns on a number of factors, including the following: (1) whether the service is provided for household use; (2) whether the service provider is a bank (or other federal insured deposit taking institution); (3) whether the service creates a debt enforceable against the customer; (4) whether the service involves a finance charge on a loan or a "time-price" charge associated with a sale; (5) whether the service is associated with a prepaid account but not a deposit account; and (6) whether the information on which the decision to provide liquidity is collected from the customer directly, third parties that have a direct relationship with the customer, or third parties that collect information from others about the customer.

This body of law and regulation is also unstable. Regulators, courts, and, of course, legislatures change the rules from time-to-time, and these changes can have significant repercussions for industry participants. The Second Circuit's recent decision in *Madden v. Midland Funding, LLC*,[16] provides one timely example. *Madden* arose from a dispute between a consumer and purchaser of debt owed by the consumer to the bank that had issued the consumer a credit card.[17] The consumer sued the debt collector in New York state court alleging that the fees charged by the debt collector exceeded the cap set by New York usury law.[18] The Second Circuit held that federal preemption was not available to the debt collector in collecting the debt pursuant to the terms of the loan agreement because the debt collector was acting on behalf of itself rather than the bank.[19] The court deflected criticism that its decision would undermine the sale of charged-off debt by banks by arguing that it "would not significantly interfere with any national bank's ability to exercise its powers under the [National Bank Act]."[20]

Among other things, Madden illustrates that the regulatory burdens and benefits are not evenly distributed in the lending space. On its face, the Second Circuit's decision creates a special privilege for banks relative to non-banks. A bank purchaser of another bank's debt can, under the Second Circuit's analysis, invoke its ability to preempt state law to block a consumer's challenge to the fees collected by the second bank based on the loan originated by the first. Most non-banks not exercising the powers of a national bank, according to the Second Circuit, have no such right.21 Both of the publicly traded platform lender, Lending Club and OnDeck, saw their valuations decline relative to traditional lenders in the wake of the decision, and commentators have attributed the relative severity of the decline to regulatory risk.22

The existing regulatory framework for regulation of non-bank lenders is a patchwork of complicated and overlapping state laws and regulations. Each state sets a different maximum interest rate that parties may contract for, and this rate may vary depending on whether the credit will be used for personal, household or family purposes (i.e., consumer credit) or for business purposes (i.e., commercial credit). In many states, consumer and/or commercial lenders may be authorized to charge interest above a state's usury cap if they obtain a state lender license—a time-consuming and expensive process. For example, a marketplace lender may contract with a Utah-based borrower for any rate of interest without a license.23 In Virginia, a lender must obtain a lender license to offer consumer loans to Virginia residents at interest above 12 percent per annum.24 In California, a license is required to engage in the business of a finance lender, regardless of what interest rates are offered.25

Lender license applications can also be quite burdensome and appear designed to deter applications. The applications often require applicants to submit background checks and fingerprints on all persons owning or controlling 10 percent or more of the lending entity, financial statements, and surety bonds. Nevada, for example, requires lenders to maintain a physical office in the state—a requirement that is particularly onerous for online lenders with no physical location.26

III. TO AVOID STATE LENDING LAWS, MARKETPLACE LENDERS ARE FORCED TO PARTNER WITH BANKS

To avoid this morass of state lending laws, a number of marketplace lenders have chosen to partner with banks. A regulatory regime where the burden of compliance is so high that companies are forced to partner with competitor incumbents to provide cost-effective products seems unequivocally problematic.

Both Prosper and Lending Club were, in their original incarnations, fairly novel. They enabled investors to fund loans extended to individuals without a traditional financial institution, either a bank or licensed lender, serving as originator. Yet although Prosper and Lending Club were serving as intermediaries between borrowers and investors, neither used the form that has dominated the consumer lending business in the United States since the early part of the Twentieth Century—i.e., a chartered financial institution such as a bank, credit union or thrift. And it was not at all clear how either company thought that it was complying with the raft of Federal and state laws related to consumer lending.27

But times have changed. In the almost ten years that have passed since Prosper got its start, Prosper and Lending Club have almost completely reinvented their businesses. Today, both companies rely on banks to originate loans. Likewise, both companies have jettisoned the direct investment approach. Under the model that both companies have now adopted, investors no longer directly fund loans to borrowers. Rather, the companies interpose intermediaries that own the right to the receivables generated by borrowers, and those intermediaries then pay investors based on the repayment history of borrowers. Although the platforms offer investors far more visibility into the performance of particular loans, the structure of the relationship between investors in the loans and borrowers is similar in form to traditional securitization.28

Viewed through this lens, the "new" platform lending businesses look pretty similar to "old" consumer lending businesses. That is, a non-bank contracts with a bank to help the bank acquirer borrowers, underwrite those borrowers, service those borrowers and manage the resulting portfolio for the benefit of third-party investors. Although some of the details have obviously evolved, the basic components of the "new" platform-lending model should be familiar to anyone who has followed the credit card industry since General Motors offered the GM Rewards card in the 1980s.29 In fact, the 1996 Narratives to the Office of the Comptroller of the Currency handbook issued for the supervision of credit card lending describes the component parts of a credit card business in terms that mirror the relationship between platform lenders, their bank origination partners, consumers, and investors.30

Having chosen to partner with a state chartered bank for the origination of the loans, Lending Club and Prosper have subjected themselves to regulatory supervision in more or less the same way that non-bank technology providers have been subjecting themselves to regulatory supervision for decades. The loans are bank products, and the banks that originate them are answerable to their regulators for the financial performance of those loans as well as the many regulatory issues that arise in connection with the issuance of such loans. In short, Lending Club and Prosper have achieved regulatory compliance by relying on banks' preemptive privileges.

IV. VARIED STATE AND FEDERAL REGULATION IN THE AIRLINE, TELECOMMUNICATIONS AND TAXI INDUSTRIES DEMONSTRATE THE NEED FOR REGULATORY REORGANIZATION

The fact that Lending Club and Prosper felt compelled to partner with a bank to reduce the regulatory burden should be understood as broad indictment of that regulatory regime. In other industries where new business models have challenged existing regulatory frameworks, the government has been willing to revise the overarching regulatory framework to ensure a functioning market. In the airline, telecommunications, and taxi industries, for example, existing regulations unfairly advantaged incumbents, thus precluding competition. To ensure a functioning market, regulatory reorganization was necessary.

Prior to passage of the Airline Deregulation Act of 1978[31] ("ADA"), airlines were heavily regulated by the Civil Aeronautics Board ("CAB"). The CAB had jurisdiction to control route entry and exist of air carriers, regulate fares, award subsidies, and control mergers and inter-carrier agreements.[32] The inflexibility of this federal regulation made it increasingly difficult for carriers to comply. A number of studies determined that economic regulation resulted in excessively high fares and a net economic loss to society at large.[33]

In an effort to avoid this stringent federal regulation, some carriers began investing in intrastate travel—a market that remained outside of CAB jurisdiction. Carriers operating in the unregulated intrastate markets were able to offer lower fares to consumers and avoid CAB regulation all together.[34] As Lewis A. Engman, then chairman of the Federal Trade Commission stated,

> **If you have any doubt that one consequence of the CAB's control over rates and routes is higher prices, you need only look at what happened some years ago in California when Pacific Southwest Airlines, an intrastate carrier not subject to CAB regulation or entry restrictions entered the San Francisco/Los Angeles market with rates less than half those being charged by the interstate CAB certified carriers TWA, Western, and United.[35]**

Fares were 30 percent less for the unregulated intrastate airlines in Florida.[36]

Eventually, economists determined that economic regulation in the airline industry was distorting the efficient performance of the marketplace. With leadership from Senator Edward Kennedy, Congress eventually passed the ADA. The ADA rescinded CAB's authority over route entry and exist, airline fares, and mandated that the CAB be dissolved by 1984. In essence, the government acknowledged that there was a problem: consumers were poorly served by a system that incentivized airlines to provide only intrastate travel.

Similarly, the telecommunications faced significant organization where state and federal regulation were set up so as to encourage monopolistic behavior. Prior to 1969, the telecommunications industry was regulated as a lawful monopoly.[37] Local telephone service was provided by an operating company of the AT&T-owned Bell System or by one of approximately 1,600 independent telephone companies. Long distance telephone service was provided by the long Lines Department of AT&T in partnership with the Bell operating companies.[38]

In 1969, however, the Federal Communications Commission approved an application submitted by AT&T competitor MCI to construct and operate a long distance telephone system between Chicago and St. Louis.[39] Effectively, however, to provide long distance service, MCI would need to rely on AT&T-owned interconnections and local distribution facilities. Although MCI and AT&T attempted to negotiate a permanent agreement regarding access to this infrastructure, negotiations failed. Among other things, MCI claimed that AT&T was unlawfully denying it interconnections and that it was being charged excessive and discriminatory prices for local distribution facilities.[40] MCI filed suit. Shortly thereafter, the Department of Justice ("DOJ") began an investigation.

Again, consumers were unable to benefit from competition in the market. And again, the government was forced to step in. After a protracted lawsuit, AT&T settled with the DOJ. Among other things, AT&T agreed to divest itself of the operating companies that provided the local exchange service. Challenging AT&T's established monopoly, new entrant, MCI effectively transformed the existing regulatory paradigm, opening telecommunications up to multiple providers and offering consumers greater choice.

This trend—new business models threatening existing regulatory frameworks—continues today. As noted at the beginning of this article, Uber poses a tremendous threat to the incumbent taxi industry. While common carrier regulations are well intentioned, these regulations were written in a time before geolocation-enabled smartphones and ride-sharing applications. They reflect and benefit regulatory concerns associated with taxi service, not peer-to-peer ride-sharing. Yet as consumers continue to use Uber's services and demand regulatory changes to support Uber's business, state governments have begun to revise state utility laws to accommodate Uber—despite taxi industry protests.

In California, for example, Uber was successful in lobbying the California Public Utilities Commission ("CPUC") to create a new category of regulated entities ("Transportation Network Companies") to cover peer-to-peer ride-sharing services. Recognizing the value of Uber's product, the CPUC altered its regulatory framework, thus expanding the market for transportation services and consumer choice.

V. LEVELING THE PLAYING FIELD BETWEEN BANKS AND NON-BANKS

In the same way that new entrants have forced re-examination of the regulatory framework for the airline, telecommunications and now, taxi industries, the effort of Prosper, Lending Club and countless others to reinvent financial services should lead regulators to re-evaluate the regulatory framework for that industry. The fact that Lending Club and Prosper have effectively joined the club by partnering with incumbents does not give regulators in this industry a pass.

Banks have a vested interest in preserving the regulatory status quo. Banks benefit from the complexity, instability and fragmentation of regulation in two ways. First, banks are incumbent providers of services that others would like to offer, and as incumbents, the complex and unstable regulatory regime serves as a barrier to entry. Second, banks have a unique ability to export the terms of the loans that they offer from the states in which are chartered to the states in which their consumers reside.[41]

There is no policy justification for giving banks and other chartered financial institutions a monopoly on the ability to export contract terms from one state to another. Although banks are subject to prudential supervision, there is no discernable connection between onsite government supervision to protect against the systemic risks that massively leveraged institutions create for the economy as a whole and banks' unique ability to exploit the efficiencies associated with the common market. Exportation of product terms is not a source or solution to the systemic risks created by the enormous leverage that lurks on bank balance sheets. In short, the risks that uniquely justify much of the supervision of banks do not also justify their sole ownership on exportation. After all, the massive risks of leveraged institutions simply are not present for online lending marketplaces or other alternative lenders. To the extent that exportation of product terms creates regulatory issues, those regulatory issues fall in the realm of consumer protection, and in the wake of the passage of Dodd-Frank, that playing field has been largely leveled with the creation of the Consumer Financial Protection Bureau.

The bank monopoly on national contracting is also a relatively recent creation. Until the mid-1960s, the prevailing rule in U.S. courts when faced with disputes about which law to apply to a lending agreement—the law of the domicile of the lender or the law of the domicile of the borrower—did not turn on whether the lender was a bank or an unchartered financial institution. Courts generally enforced the law of the lender, rather than the borrower.[42] When the prevailing judicial approach to conflict of laws changed in the 1960s, banks sought new ways to ensure that their contracts could be enforced on a nationwide basis, and courts eventually latched on to the pre-emptive force of federal banking statutes. Although non-banks cannot currently claim a similar right, they could regain the ability to export terms if courts simply reverted to the conflict rule that used to apply to lenders regardless of charter—i.e., that the law of the state of the lender, not the borrower, governs the relationship between the two.

VI. CONCLUSION

The broader point goes well beyond giving non-banks the same ability to contract across state lines as banks. In the financial services industry today, as in the telecommunications and transportation industries a generation ago, competition has essentially been lost as a guiding regulatory principle. Regulatory compliance has become an economic moat that existing providers are using to fend off disruptive competition. Rather than looking for ways to force upstarts to join with those incumbents, regulators in this industry should look for inspiration in the examples of the past and find ways to level the regulatory playing field. Leveling the playing field will ensure greater consumer access to better financial products.

1 Thomas P. Brown is a partner and Molly E. Swartz is an associate at Paul Hastings LLP. The views expressed are entirely their own. Their views do not represent the view of the firm or any client of the firm

2 Dana Rubenstein, "Uber Publicly Embraces Regulation, the 'Modern' Sort," *Politico New York*, October 29, 2014, http://www.capitalnewyork.com/article/city-hall/2014/10/8555647/uber-publicly-embraces-regulation-modern-sort.

3 For purposes of this paper, we use the phrase "marketplace lenders" to distinguish between bank lenders and technology driven lenders. In our experience, however, this taxonomy is a bit narrow in that technology driven lenders follow two variations—(1) those that involve discrete sources of third-party capital and are generally described as "marketplace lenders" such as Prosper, Lending Club, and OnDeck; and (2) those that lend off their own balance sheet such as PayPal Credit but that use an essentially identical origination model and are generally described as "platform lenders."

4 "Epic Consumer Credit Crunch Unfolding," *Seeking Alpha*, March 2, 2010, http://seekingalpha.com/article/191517-epic-consumer-credit-crunch-unfolding.

5 Andrew Verstein, "The Misregulation of Person-to-Person Lending," *U.C. Davis Law Review* 45, (2011): 445, 457.

6 *Id.*

7 15 U.S.C. §§ 1601 *et seq.*

8 15 U.S.C. §§ 1681 *et seq.*

9 15 U.S.C. §§ 1693 *et seq.*

10 15 U.S.C. §§ 1691 *et seq.*

11 12 C.F.R. §§ 1026 *et seq.*

12 12 C.F.R. §§ 205.1 *et seq.*

13 Cal. Const. art. XV, § 1.

14 Cal. Fin. Code §§ 22000 *et seq.*

15 Cal. Civ. Code §§ 1750 *et seq.*

16 *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

17 *Id.* at 247-49.

18 *Id.*

19 *Id.* at 245-53.

20 *Id.* at 249.

21 *Id.* at 251 (stating that "[i]n most cases in which NBA preemption has been applied to a non-national bank entity, the entity has exercised the powers of a national bank—i.e., has acted on behalf of a national bank in carrying out the national bank's business. This is not the case here."). *See also Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 308, 313-316 (1978) (holding

that a federally chartered bank may offer loans to consumers in any of the other 49 states at any interest rate allowed by the bank's state of residence regardless of whether the consumer's home state recognizes a lower usury cap); *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996) (holding that the NBA preempts state limits on fees as well as finance charges).

22 Leena Rao, "Once-hot Online Lending Companies Go Cold in Face of Skepticism," *Fortune*, June 30, 2015, http://fortune.com/2015/06/30/lending-club-ondeck-shares.

23 Utah Code Ann. § 15-1-1 (West).

24 Va. Code §§ 6.2-1501, 6.2-303.

25 Cal. Fin. Code § 22100(a).

26 Nev. Rev. Stat. §§ 675.090(2)(a); 675.090(3).

27 Eileen Ambrose, "Peer-to-Peer Lending Alternative Runs into a Regulatory Wall," *Baltimore Sun*, December 7, 2008, http://articles.baltimoresun.com/2008-12-07/business/0812060058_1_lending-sites-peer-to-peer-lending-prosper-loans (stating that "Peer-to-peer lending . . . recently has come into regulators' sights . . . [sidelining] the largest peer-to-peer lending site, Prosper.com," and also quoting Lending Club CEO's statement that he "concluded that the industry was headed toward regulation.").

28 Jane Kim, "Peer-to-Peer Lender Relaunched," *Wall Street Journal*, April. 28, 2009, http://www.wsj.com/articles/SB124088142201761953; Prosper Funding LLC, August 2015 prospectus for up to $500,000,000 in principal amount of Borrower Payment Dependent Notes at *10, https://www.prosper.com/Downloads/Legal/Prosper_Prospectus_2015-08-13.pdf ; Lending Club, August 2014 prospectus for Member Payment Dependent Notes at *7, https://www.lendingclub.com/fileDownload.action?file=Clean_As_Filed_20140822.pdf&type=docs.

29 David S. Evans and Richard Schmalensee, *Paying with Plastic* (Cambridge: The MIT Press, 2005), 78-79.

30 *See* OCC Credit Card Handbook 1996 at 12 ("Although some institutions develop their own scoring models, most are built by outside vendors."); *id.* at 5 ("Issuing banks often employ outside vendors to perform solicitation, servicing, collections, or other functions ….").

31 Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 49 U.S.C.).

32 Andrew R. Goetz and Paul S. Dempsey, "Airline Deregulation Ten Years After: Something Foul in the Air," *Journal Air Law and Commerce* 54, (1986): 927, 929.

33 *Id*. at 930.

34 *Id*.

35 Christine Chmura, "The Effects of Airline Regulation," *The Freeman*, *Foundation for Economic Education*, August 1, 1984, http://fee.org/freeman/the-effects-of-airline-regulation/ quoting Lewis A. Engman, "Regulating Industry," *Washington Post*, October 15, 1974.

36 Id. quoting Robert Lindsey, "Airline Deregulation is Weighted," New York Times, February 7, 1975, p. 39.

37 MCI Communications Corp. v. American Tel. & Tel. Co., 708 F.2d 1081, 1093 (7th Cir. 1983)

38 Id.

39 Id. at 1094.

40 Id. at 1096.

41 12 U.S.C. § 1831d; Greenwood Trust Co. v. Mass., 971 F. 2d 818, 826 (1st Cir. 1992).

42 Ury v. Jewelers Acceptance Corp., 227 Cal. App. 2d 11 (Ct. App. 1964).

A SYMPOSIUM ON THE TENCENT CASE

Legal boundaries of Competition in the Area of Internet: Challenges and Judicial Responses

By Zhu Li [1]

ABSTRACT

Some new characteristics of competition in the Internet industry, e.g., competition for attention, innovation competition, cross-market competition etc., have brought about new challenges and difficulties for the legal regulation of competition. In virtue of the theoretical innovation and the innovation of law applicability, Chinese courts gave creative judicial responses in the scopes of Anti-Unfair Competition Law and antitrust Law, clarified the legal boundaries of competition and effectively regulated competition in the online environment. Certain trends and rules implicit in this kind of judicial responses are worth noting.

The growth of the Internet industry in our country has become a new engine for the development of domestic economy. The online technology has been updating rapidly; new products, new services and new business models have been emerging uninterruptedly, impacting existing models and established order of the traditional commercial community, changing the structure of commercial interests in the economy and the society. This process is accompanied with the increasingly fierce competition in the Internet area and the continuous emergence of new kind of competition that constantly challenge legal boundaries. At the early stage of Internet development, the challenge had mostly appeared to be the difficulties in protecting online copyright. In pace with the maturity and progress of the Internet technology, the scale of e-commerce enlarges rapidly, new business models relying on the Internet are emerging uninterruptedly, therefore the mentioned challenge has expanded to areas such as trademark protection, competition regulation, etc. in the Internet. By examining specific cases, Chinese courts have clarified and delimited competition rules on the internet, filled the legal gaps, and thus, played an important role in the regulation of competition on the Internet. First, the paper describes the characteristics of competition on the Internet. Second, it explores the special challenges this kind of competition has brought to the judicature, and third, the paper will analyze the creative judicial responses to the challenge, and endeavor to reveal the trend and the regular pattern in such judicial actions.

I. BASIC FEATURES OF COMPETITION IN THE INTERNET AREA

A. Competition for attention

The expansion of information continues constantly in Internet, whereas everyone's time and energy are limited and valuable. Hence, Internet users' attention has become a scarce resource. Each Internet service provider tries to do its best to obtain customers' attention and to focus it on its product by virtue of its particular tools, operations and services in purpose to gain its business benefits through customers' attention.[2] There are two ways to turn customers' attention into business benefits: 1) to develop value-added services for interested customers and thus gain profit and 2) to sell the gathered customers' attention to a third party that seeks this kind of resource. Baidu, for instance, has gathered great amount of Internet users via its search engine platform and then began to gain business benefit by selling advertising or by offering value-added services.

The competition to obtain customers' attention in online environment has derived three subsidiary features. First, the zero price (or negative price) competition. Internet service providers have found in the competition of obtaining customers' attention that the most effective way to attract customers' attention is zero price, or even negative price. Zero prices for basic services have become a mainstream business model of Internet service providers. Recently, for instance, in areas of instant messaging, search, social networks, security, e-commerce etc. all providers offer their basic services for zero prices. In some areas of intensive competition providers prefer even negative price competition by subsidizing customers in order to continuously attract and maintain users' attention. Second feature is the platform competition. In the online environment the operations and services offered by the providers are increasingly platform-related. Services, offered by Internet service providers, turn to be the platform, connecting two or more groups of different entrepreneurs who take part of business via the platform; in this form of business the benefit of one group of participants by joining the platform depends of the scale and the development of another group of entrepreneurs joining this platform. Internet service providers who offer the platform service will "create value by virtue of reducing the conflict between different participants of the platform or lowering the transaction cost." [3] Internet service provider will continuously increase the user's dependence on their platforms and improve customer stickiness by virtue of offering added particular function that other platforms cannot propose or supplying the function of better quality than that of other platforms. Third of these features is the motto "the customer is the king." Internet service providers pay high attention to customers' needs, constantly update their products or offer new type of services, and this way attempt to improve the users' experience, to enhance the attractiveness of their products and services, and finally to keep customers.

B. Innovation competition

Given the new ways to disseminate information and the speed to do so, Internet, to a large extent, provides endless resources and spaces to expand innovation. The magic weapons in the competition are rapid innovation and seize and keep customers as soon as possible. In the area of Internet the focus of innovation is shifting from traditional innovation of technology and production to innovation of business models, and the leading innovation factor is to shift from a closed mode of innovation to an open one. That is, innovation is no longer limited to the companies' development centers, but opened to the community, providers and end-users, and innovation is carried out in accordance with customers' demands and ideas. No doubt that in online environments the customer is the decisive factor for the survival of the enterprise, creativity is the leading factor for development of the enterprise. Competition in online environments appears to be a dynamic competition, where operators attempt to build their competitive advantage by virtue of constant innovation. "The period for leading enterprises of many industries to keep their dominant position is getting shorter. Enterprises resting on their dominant position and revealing their former laurels will soon be replaced by more innovative competitors."[4] Meanwhile products and services differentiation offered by different providers is becoming more relevant. Providers compete for customers by offering different functions and user experience.

C. Cross-market competition

Another obvious feature of competition in the area of Internet is cross-market competition. Products and services, offered by a typical network provider, are mostly based on software and provided via Internet, where the market entry threshold is not very high and the cost of changing the scope of products and services is relatively low. Thus, the network provider can easily bring its existing customers into a new area by adding services without customer churn, if he has already obtained massive customer resource. Therefore, in the area of Internet, service providers who offer different products and services are used to look at each other as competitors and do not stop to compete for customers' attention.

D. Huge impact

The scope, magnitude, breadth, and depth of impact caused by competition behavior may expand unlimitedly and spread to the entire Internet environment in a very short period of time; it is difficult to eliminate the result of such impact effectively. An Internet service provider that faces intensive competition could suffer customer churn for a couple of days, lose its competitive advantage and even be forced to withdraw from the market.

II. CHALLENGES BROUGHT TO COURT BY COMPETITION IN THE AREA OF INTERNET

The abovementioned characteristics of the competition in the area of Internet have brought about new challenges to court, concerning at least three aspects: changes of judicial functions; industry's stronger expectation of reasonably determined legal rules; right holders' higher requirements for the prompt and effective judicial relief.

A. Changes of judicial functions

It is often difficult for the law to timely respond to changes, occurring when technology and business models are developing dramatically. At the same time it is also difficult for the administrative law enforcement organs to promptly investigate the competitive behavior in the area of Internet due to lack of a clear basis for enforcement. The court is thus inevitably pushed to the forefront of solving disputes of network competition. According to an incomplete statistics report, Chinese courts have heard 126 cases involving disputes of unfair competition in the internet industry as of October 2014.[5] These disputes demonstrate the following characteristics: disputes occur frequently and easily shift along with hot new technology and revolution of business models; numerous disputes occur due to new type of competitive behaviors that are not yet clearly regulated by law and are to be adjusted by applying the guidelines of anti-unfair competition law; many disputes are tentative, i.e. the purpose of the litigation parties is not just fighting the interests of the pros and cons, but rather requiring the judiciary clear industry rules and code of conduct; disputes between Internet service providers, spreading to disputes between traditional enterprises and Internet service providers, appear to be intense competition for each one's own interest. Thus, it becomes a major issue for the courts to provide proper administered judicial rules for new type of competitive behaviors, to guide and regulate healthy competition while resolving disputes. That means that the justice must assume not only the functions of legal performer of competition law, but also the functions of competition policy/rule maker. Along with implementing national strategy of establishing an innovative country and accelerating the pace of innovation-driven development, the role of competition policy is increasingly prominent. "The closer the forefront of knowledge, the higher the complexity and uncertainty."[6] The lower the accuracy and efficiency of industrial policy and the greater the role and value of competition policy, the more urgent of demands to maintain a healthy competitive environment. The actual situation requires justices to define the legal boundaries of the legality of acts by virtue of creative application of the law in every specific case, "bridging the gap between law and constantly changing reality." [7]

To perform this function properly and to creatively apply the law, the justice needs to be not only proficiency in the spirit of the law and rules, but also to have a deep understanding of the competition reality in the area of Internet, knowledge of information technology and a good understanding of the business development model and innovation requirement. In the process of dealing with some knotty disputes of competition in the area of Internet, the court, applying guidelines of Article II of the Anti-Unfair Competition Law, has carried out certain exploration of the standard of legitimacy of competitive behavior. In *Baidu, Inc. vs. Qihoo* case of violation of robots protocol, the trial court, for instance, has put forward the rule of procedures of "consultation-notice." [8] In *Baidu, Inc. vs. Qihoo* case of inserted standard, the trial court has put forward the principle of "no interference in case of non-public necessity." [9] These explorations have, to a certain extent, deepened the understanding of the principle of Article II of the Anti-Unfair Competition Law. These explorations have, of course, sparked considerable controversy that demonstrates a fact that a relatively broad social consensus is not yet established in this area.[10] The justice still has to take a heavy burden and to embark on a long road for properly shaping the rule of law, responding to demands of market and uniting social consensus.

B. Difficulty of legal evaluation

The competition for obtaining customers' attention, innovative competition and cross-market competition with the retrofit of competition means in the area of Internet leave a gray area where competition bears the characteristics between legality and illegality that cause serious difficulty of legal evaluation. The difficulty is reflected in the scopes of anti-unfair competition and antitrust laws.

This difficulty is mainly reflected in two aspects of unfair competition. One of them is the problem of judging the competitive relationship. In civil cases of unfair competition, the traditional theory and practice of the anti-unfair competition law sets the existence of competition between the plaintiff and defendant as the preconditions for relief of the plaintiff. In the online environment the real and strong competition exist also between the operators of different products and services due to the competition of obtaining customers' attention, platform competition and cross-market competition. Many victims of unfair competitive behaviors cannot be protected by law, if the existence of competition (even direct competition) remains to be the precondition for legal remedy. It is thus appears to be the theoretic and practical issue the justice should address to re-identify the competitive relationship and to re-define the competitive relationship in anti-unfair competition law.

Another aspect of the difficulty mentioned above is to judge the legitimacy of competitive behavior. Unfair competitive behaviors in the Internet environment are carried out mostly by means of the implementation of information technology and often in the name of technological innovation with powerful technical features. Operators tend to defend their competitive behaviors on the excuse of necessary measures to meet customers' demands. The competitive behavior of one operator usually does not immediately have an impact on its competitor, but it does through the customer as the intermediary, i.e. the customer's interest is kidnaped by the Internet service providers who exploit their customers as a shield to fight their competitors for their own business benefit. In comparison with traditional competition, competition in the Internet environment is more neutral, at least on the surface; its boundaries of legitimacy are blurred. Technological and neutral features of competitive behaviors make more difficult to define the subjective fault of the operator and the economic effects on competition. Under certain conditions, the competitive behavior, though injuring the competitor, can enhance consumer's welfare or it might impact consumer's welfare for a short time, but can enhance consumer welfare in the long term. The traditional anti-unfair competition law simply defines the boundary of legality based on the virtue of typical characteristics of conducts. Such a method could not be used in an online environment.[11]The "technologization" of competition increases the relevance and interdependence of competing operators: products and services offered by one provider, inevitably relate to products and services offered by other providers, and thus will impact the business of the latter. The standard of competition and business achievement is characterized by competing for its own business results and trying not to disturb others. Such standard increasingly shows its drawbacks in judging the justification of competition since it has wider scope of attack and hampers free competition.[12] Meanwhile, the innovation in area of Internet is frequent, competition is complex and evolving. It is thus difficult to form commonly recognized business ethics timely. It is increasingly difficult to seek an ethical consensus in a fragmented, divided society. The moral evaluation criteria, applied in traditional anti-unfair competition law, is fallen in straitened circumstances, it is thus not an easy task for us to extract stable and clear legal criteria.

Competition in the area of Internet also seriously challenges the applicability of antitrust law. First of all, the difficulty in defining the relevant market. The zero price competition and the platform competition and other features of competition in the area of Internet have brought about greater uncertainty in defining the relevant market. Theorists and practitioners are debating whether the free market under conditions of zero price competition is the relevant market in sense of antitrust law and how to carry out Hypothetical Monopolist Test ("HMT") in this circumstance. Influenced by the platform effect due to the existence of bilateral or multilateral market, the market boundaries in the area of Internet are characterized by the high ambiguity and thus far less clear than that of traditional market. The widely applicable method for market definition in traditional areas cannot therefore be directly applied to define the relevant market in the area of Internet. Another issue is the increasing difficulty to define the abuse of dominant market position. Under the condition of blurred market boundaries the market share has significantly reduced its role of indicators, which used to measure the enterprise market forces. The probability of miscarriage of justice will increase in case of defining the dominant market position based solely on market shares. It is hence an urgent issue, which the justice must resolve, to improve the rationality of definition of the dominant market position and the abuse of dominant market position.

C. New demands of judicial relief

The competition in area of Internet is a far-reaching behavior, it increases rapidly, is hardly eliminated so that the survival of some enterprises will be threatened. The characteristics of Internet competition have proposed new requirements of the timeliness and effectiveness judicial protection. If the innovation and fair competition of an enterprise cannot be promptly protected, the enterprise might fall into the dilemma of "won the lawsuit, but lose the market," even if it could ultimately succeed in the litigation. From the point of view of judicial precedents the most serious problems the Parties complain about are insufficient compensation, delayed temporary remedial measures etc. Among more than 120 cases of disputes of unfair competition in area of Internet, the amount of highest compensation is RMB 5 million, only 4 percent of the claim of the Party of this case.[13] The case of genuine "Kaixin001" had lasted more than one year, the corporation, though had won the litigation and got RMB 400,000 for compensation, had lost its market share, eroded by its competitors, and had not been able to reemerge. The function of judicial relief, suffering great shortage in the timeliness and effectiveness, cannot yet fully meet the demand of competition in area of Internet.

III. CREATIVE RESPONSES AND ADJUSTMENTS FROM THE JUDICIARY

A. Innovation and breakthrough of competition theory

The new characteristics of competition in the online industry (e.g. competition for attention, cross-market competition etc.) have redefined the competitive relationships and the role of judicial relief in unfair competition cases. Judicial precedents have to break through the limitations of existing theories by resorting to theoretical innovation. In *Baidu Inc. vs. Unicom Qingdao*, Osun Network and others, for instance, the appeal court held:

> **There exists competition between Unicom Qingdao and Baidu Inc, insofar as Unicom Qingdao has carried out the commercial activity of poping-up ads prior to the result of Baidu search. Thus, Unicom Qingdao competes with the paid search activity of Baidu, although Unicom Qingdao (network provider) and Baidu Inc. (provider of search service) offer entirely different services.** [14]

This definition has broken through the theoretic limitation of direct competition and included indirect competition. Summing up precedents, the Supreme Court further points out in its justice policy: "the competitive relationship should be correctly defined, i.e. among all competitors that take part in the market and are impacted by the unfair competition. Between them, there exists competitive relationships, no matter if it is direct competition or not."[15] According to this justice policy, the competitive relationship between operator A and other operators, whose business is impacted by the competitive behavior of operator A, can be defined as such. In *Heyi Information Technology (Beijing) Co., Ltd vs. Security Software Company Kingsoft Corp*. about "Cheetah browser shielded video advertising" the appeal court had proposed two conditions to define a relationship of competition: whether the behavior of the operator can harm the interest of other operators; whether the operator can gain actual or potential benefit by virtue of this behavior. Meanwhile the trial court held that the criterion to define a competitive relationship does not rely on whether competitors are of the same industry.[16] It can clearly be seen that the position of the trial court is actually the specific application of the Supreme Court' justice policy. To a larger extend, competitive relationship means that the importance of a competitive relationship is declining to find unfair competition. Moreover, trial courts do not even carry out particular investigations of the competitive relationship between the parties in many cases, which means that the competitive relationship can no longer be an obstacle to define unfair competition. Thanks to the theoretical innovation the justice has broken away with the legal predicament based on the narrow understanding of competitive relationship, and thus has met the characteristics of competition in the online industry.

B. Adjustments of judging the fairness of competitive behavior

Given the new features of competition on Internet such as technicality, neutralization, and complexity of the effect of interests, courts have proposed new alternatives to judge the fairness of competitive behavior and new methodological adjustments.

First, the criteria of business ethics tend to be objective. In the traditional commercial sectors, business operators have formed commonly accepted business ethics. These ethics become dominant in determining the fairness of competition behaviors. "All competitive behaviors, violating conventional honest practices in commercial activities, constitute unfair competition."[17] The justice policy of the Supreme Court points out:

> **Any action, even if it is not forbidden by a particular provision of the anti-unfair competition law, can be regulated in accordance of the provisions of the applicable principles, if such action can be defined as unfair by harming the legitimate rights and interests of other operators and violating the principle of good faith and commonly accepted business ethics, and the fair competition order cannot be maintained without ceasing such action.** [18]

Meanwhile, to prevent generalization and subjectivity of moral judgment, the judicial practice defines the business ethics as "standards of behavior, generally recognized and accepted in specific business areas, its objectivity is embodied in its common acceptance and commonality." [19] The criterion of business ethics continues to play an important role in the definition of fairness in the new type of competition in Internet. Nevertheless, the commonly accepted business ethics of Internet business is still at the stage of formation and development due to the innovation and rapidly developing competition in this area. The court has to seek a more objective form of business ethics when applying the business ethics as the standard of the competition fairness evaluation. In the cases of "QQ Guards" and "Robots Protocol," the courts had considered the industry standards and self-regulation in Internet as an important origin of the criteria for discovery and definition of standards of conventional industry behaviors and commonly accepted business ethics.[20] The standard of behavior is the means of administration, whereas self-regulation is the means of self-management of operators in the industry, both means do not exactly accord to commonly accepted business ethics. Therefore, the courts emphasizes that it is necessary "to rely on the judgment of their legality, impartiality and objectivity, (the mentioned) relevant means can be taken as references for defining standards of conventional industry behaviors and commonly accepted business ethics in Internet." [21]

Second, evaluating the effect of competitive behavior has become more important in the judgment of its fairness. The objectivity of business ethics in Internet is getting more difficult because of the technicality and neutralization of competitive behavior. Therefore, courts began to pay attention to the evaluation of the effect of the competitive behavior and seek to justify the fairness of the behavior by assessing the impact of the behavior on the legal interest protected by competition law. In the case of "Cheetah browser shielded video advertising," the civil court had investigated and analyzed the harm that Heyi Information Technology (Beijing) Co., Ltd has suffered due to the behavior of "Cheetah browser shielded video advertising" based on the behavior's perspective effects, and assessed the long-term impact on the interest of customers and public interest. Then came to the conclusion that the behavior of "Cheetah browser shielded video advertising" constituted unfair competitive behavior.[22]

More cases demonstrate a new mode of evaluating the fairness of behavior: the judgment is carried out on the basis of comprehensive evaluation of the impact of competitive behavior on the interest of competitors, the interest of customers and the public interest of society. The analysis of the harm that the operator suffers as the result of competitive behavior is set to be the logical starting point. For the operator's interest is the object, directly protected by the anti-unfair competition law. All concerned cases have considered the impact on operators through competitive behavior. The customer is the object of competitive behavior that bears the result of competition and accepts the market products; it is therefore the final aim of justice to enhance consumers' welfare. It should be an integral part of the judgment of fairness of competitive behavior to consider the impact of competitive behavior on the customers' interest with respect of enhancement of consumers' welfare and their fundamental benefit. The customers' interest is itself multilevel and relative due to differentiation of consumer groups and their divergent interests. Trial courts have been paying attention to this issue and assessing the different interests of consumers with different weights. Trial courts have been following more closely the influence of competitive behavior on the right of customers to know and to choose; to harm this type of customers' interest will more likely be confirmed to constitute unfair competition. Present judicial precedents demonstrate that the positive customer experience and other kind of customers' interest that can be resolved via the market do not have a significant impact on evaluating the fairness of competitive behavior. On this basis, many judicial precedents have investigated the impact of competitive behavior on the public interest of society and analyzed whether this kind of behavior could harm the healthy mechanism of market competition. The method of comprehensive evaluation of negative and positive results is very close to the principle of rationality for antitrust analysis; it indicates the integration and interoperability of the anti-unfair competition law and the antitrust law.

Third, the trend of multi-angle evaluation. Because there is no conflict between criteria of moral evaluation and criteria of evaluation of competition result, the nationality and persuasiveness of the evaluation result will improve if the fairness of competitive behaviors is inspected under various angles, e.g. moral evaluation, efficiency competition, principle of proportionality, assessment of competitive effects etc. The typical cases of application of this method are "QQ guards" and "Cheetah browser shielded video advertising."

C. Innovation in application of antitrust law

The competition in the Internet industry obviously differs from the competition in traditional areas. The logic of analysis and method, widely applicable for monopoly behaviors in traditional areas, cannot be applied directly in the Internet industry. The justice has carried out targeted adjustments and innovation in accordance with the competitive features on the Internet.

First, innovation in the analysis of abuse of dominant market position cases in the Internet industry. In the traditional antitrust law there are three patterns of analysis of abuse the dominant market position: patter 1 "relevant market-market power- competitive effects (R-M-C)", for which the definition of relevant market is the insurmountable starting point of analysis of the monopoly. Pattern 2 "market power - competitive effects (M-C)", for which the starting pint of analysis is the definition of market power that can be tested and verified by virtue of direct or indirect evidence. Under this pattern of analysis the definition of relevant market can be circumvented. Pattern 3 "behavior - competitive effects (C-C)".

For traditional antitrust judicial cases, pattern 1 is currently the leading pattern of analysis in European and American courts, whereas pattern 2 is rarely applied in practice, and pattern 3 has not yet been applied. In Internet, the boundaries of relevant market are obscured even more due to the competition for customers' attention, the platform competition and cross-market competition. Thus, the justice should keep the necessary caution when applying R-M-C patter and apply the two latter patterns as the preferred tool of analysis. Chinese courts have carried out valuable attempt in this relation. In *Qihoo 360 Technology Co Ltd vs. Tencent computer system Co. Ltd*. of abuse the dominant market position, the trial court, in an in-depth investigation of the relevant market concerned and analyzing the market power of Tencent in this market, had come to the conclusion that Tencent company does not possess the dominant market position. Yet the trial court did not cease the investigation and analysis at this point, but had further evaluated the actual or potential effect of the respondent monopolistic behavior on the market competition and had carried out the final judgment on this basis.[23] For this method of analysis of the relevant market, the market power and the effect of competitive behavior are considered related and referenced factors, but not separate stages of analysis; the rationality of the definition is thus improved due to a cross-verification of all mentioned factors. For this method of analysis, these three patterns can be flexibly chosen in accordance with a particular case. The C-C pattern could be chosen when it seems to be difficult to define the relevant market and the market dominant position, thus the relevant market could lie beyond a clear definition. The caution should be kept in finding the indicator effect of market share on the basis of features of online competition even when the relevant market and market share are defined by using the former two patterns. In this case factors such as market entry, market behavior and economic results become the focus of attention.

The competition in circumstance of Internet is highly dynamic, the boundaries of relevant market are thus far less clear than that in traditional areas, the indicator effect of market share in this case should not be overvalued, more attention should be paid to those factors such as market entry, market behaviors of operators and their influence on the competition etc. which can help to determine the facts and evidence of dominant market position.[24]

Meanwhile trial courts have applied more flexible methods to analyze various factors with respect to the particularities of the competition in Internet: when defining relevant market of goods and services of relative platform features, possessing certain but not very close substitution, such products and services could be involved in consideration of the influence on the behavior of hypothetical monopolist, no matter whether they can be included in the scope of relevant market or not. When determining the dominant market position, the analysis of the result of competition should not be abandoned even after certain preliminary conclusions, the consideration of the result of competition and the verification of the accurateness of judgment of the dominant market position should be carried out further.

Second, adjustment of Hypothetical Monopoly test ("HMT"). In *Qihoo 360 Technology Co Ltd vs. Tencent computer system Co. Ltd*., the trial court had explored the applicability of HMT in the online industry and the method of its specific application. The trial court held that, as a method to analyze relevant market, HMT has universal applicability, yet the particular analysis by means of HMT should be carried out in dependence of the area of market competition, concerned in the specific case, and the relevant data that can be obtained. Competitors in the area of Internet pay more attention to quality, services, innovation etc., but not price. Customers have very high price sensitivity, so to them, it would seem a great change of the features of products and the business model, if free products or services would have turned to paid ones. The HMT in terms of price increment is thus not fully applicable in area of Internet, yet the alternative forms of this method, e.g. HMT on the basis of quality degradation, could still be applied.

Third, innovation in the method of analyzing relevant market and market power, related to multi-sided platform cost-free for users. Economists usually apply the method of conversion analysis for defining relevant market of platform products or services for charge-free users by regarding the charge-free basic services as the investment for platform products with the purpose of converting the market of platform product to common and paid single market.[25] This method, though simple and convenient, might not only exaggerate the influence of platform competition, but also to certain extent neglect the connection and interaction of both ends of the platform; it is hence neither scientific nor accurate. In *Qihoo 360 Technology Co Ltd vs. Tencent computer system Co. Ltd*. the trial court did not apply this method of analysis, but, had investigated whether the features of platform competition can affect the definition of relevant market based on "whether the competition between online platforms, competing for customers' attention and advertisers, totally steps over the boundary determined by the features of products or services and thus imposes sufficiently strong competitive constraint on operators,". The trial court had chosen the free instant messaging service as the criterion to define the relevant market because of the absence of exact empirical data that could prove that platform competition has imposed sufficiently strong competitive constraint on operators, as well as in case that the competitive behaviors involved in litigation occur mostly at the free users' end. At the same time, the trial court did hot neglect the influence of platform competition by taking it in proper consideration when defining market position and market power. We see that the trial court has flexibly applied the new method of analysis for specific case when economics is not yet able to supply any more persuasive pattern of analysis for relevant judicial cases. The revelation is: for platform-related products or services there is no fixed pattern of analysis, the relevant market and dominant market position should be determined depending on each specific case. What the court has to do is to take into consideration features of platform and the interaction of both ends of the platform, and then accurately identify the actual or potential competitive constraint the operators can face.

Fourth, advocate for an objective and effect-oriented method of analysis. The antitrust action follows closely whether the respondent monopolistic behavior will distort and destruct the healthy, orderly and energetic competition mechanism. Such action "has involved in itself neither moral content nor ethic law, appropriately designed for business."[26] In the antitrust case the important thing is industry reality and economic rationality, the moral thinking must thus be avoided. One should search the original sin of monopoly merely in competition result and economic reality. In *Qihoo 360 Technology Co Ltd vs. Tencent computer system Co. Ltd.* the trial court did not carry out any moral evaluation of "either-or" and other behaviors of Tencent, but had focused on the effect of the respondent monopoly behaviors. After a comprehensive evaluation of the actual and potential passive and positive results that these behaviors caused, the court came to the conclusion that such behaviors were legal. In this process, the trial court had followed the method of investigation that especially focuses on a specific industry and in a specific behavior. In other words, to investigate a specific behavior of a specific industry with respect to the characteristics of the respondent monopoly behaviors and its impact on the competition, to consider in detail platform effect and network effect on each specific case, and thus to more accurately determine the impact of behavior on the competition.

Fifth, the creative combination of legal judgment and economic analysis. The analysis and judgment of legality of the monopolistic behavior usually relies on the economic analysis, yet the ultimate decision will be carried out by the judge. The economic analysis only makes available different tools for the proper legal judgment; the judge cannot thus transfer the right to rule to economists. Therefore the judge should creatively combine the legal judgment and the economic analysis in the antitrust case by properly applying the conclusion of economic analysis for improving the accuracy of legal judgment of monopoly behavior. In *Qihoo 360 Technology Co Ltd vs. Tencent computer system Co. Ltd*. the trial court, analyzed whether the acquisition costs of mobile terminal equipment constituted an obstacle for including the mobile instant message service in the relevant market. In doing so, it considered that for the customer who possesses both mobile terminal device and a PC, the acquisition costs of mobile terminal equipment had already become sunk costs. This fact cannot be changed due to any current or future decision of the provider, the acquisition costs cannot any way influence on the customer's choice between mobile terminal device and PC as the preferred equipment for instant message. Thus, the court came to the conclusion that acquisition costs of mobile terminal equipments will not constitute any obstacle for including the mobile instant message service in the relevant market in this case. This is a typical example of applying economic commonsense in a specific case.

According to economists, the trial court has carried out even more professional price-related analysis determining whether social network Weibo and instant message can be included in the same relevant market.[27] This is an example of combination of economic analysis and legal judgment. For a correct and reasonable application of economic analysis, the methodological errors should be prevented and the limitation of data and constraint of conditions should be properly considered. A judge should break away from arrogance and prejudice when applying the method of economic analysis and adopting a conclusion. It is important for justice that the judge, besides the necessary economic knowledge, maintains the principle of "effect first." In other word, the judge should follow closely the actual or potential effect of respondent monopoly behaviors on competition, and in doing so, adequately apply the economic analysis and stay away from possible methodological errors, limitation of data and constraint of conditions. The more realistic, more rational and more accurate conclusion of the legal identification of monopolistic behavior can finally be drawn as long as the essence of the monopolistic behavior that causes actual or potential negative effect on the competition will be grasped. The result of the economic analysis based on direct evidence will be verified pursuing to the "effect first" principle. This could explain the judicial action in *Qihoo 360 Technology Co Ltd vs. Tencent computer system Co. Ltd.*, where the trial court, applying an economic analysis, investigated whether the monopoly's actions will exclude or restrict competition on the basis of almost all testimonies related to the effect of its behaviors.

IV. CONCLUSION

From the point of view of interpretation and application of substantive law, the analysis abovementioned demonstrates that the justice has creatively responded to the competitive behaviors in an online environment. It also clarified legitimacy boundaries of competitive behaviors, and thus effectively regulated competition on Internet. Some responding measures and innovation of applicable judicial methods has had a profound influence on international justice. Yet, needless to say that there are a lot of shortcomings of the responding measures and methods mentioned, e.g., there are many misunderstandings, even mistakes in dealing with the correlation between anti-unfair competition law and antitrust law with respect of applying the substantive law. There exist more or less specious and vague criteria for judging the legitimacy of competition; the economic analysis of monopolistic behavior and the assessment of the competitive effects are not yet well skilled; the lack of timely and effective judicial relief seriously impacts and limits the fully implementation of judicial efficiency. A further improvement is to be planned in the future judicial practice.

1 Zhu Li, the Judge of the Intellectual Property Division of Supreme People's Court, JD. The article represents only the author's own views beyond the position of its organization. Certain content of this paper was discussed and reviewed in "Chinese IP judges Forum" of Southwest University of Political Science & Law, № 4, as well as in the second meeting of the Forum Internet Competition Policy and Innovation, organized by the Electronics Intellectual Property Center of Industry and Information Technology Ministry. Thanked the participants of the forum for their comments, certainly the author is responsible for any error in this paper.

2 "Many network providers are competing in order to obtain the limited attention of consumers, their featured products and services are in fact just the tools to gain the customers' attention in competition." David S. Evans, "Attention Rivalry Among Online Platforms," *University of Chicago Institute for Law & Economics,* no. 627 (2013): 3. Available at SSRN: http://ssrn.com/abstract=2195340.

3 Cited from David S. Evan, "Market Definition and Market Power for Internet Industries" (discourse in Seminar of Implementation of Antitrust Law in ICT Industry of the Forum Internet Competition Policy and Innovation, organized by the Electronics Intellectual Property Center, 24 march, 2015).

4 Jian-cai Zhang, "Dynamic competition and enterprise core competitiveness," *East China Economic Management*, no. 4 (2002): 81.

5 For particularities of dispute of competition in the area of Internet *see* Qin-kun Zhang, "A empirical analysis of unfair competition cases of Internet development in China," *Electronics Intellectual Property*, no. 10*,* (2014): 26-37.

6 [6] Rajneesh Narula, *Globalization and technology: Interdependence, innovation systems and industrial policy,* (Blackwell Publishing Ltd., 2003).

7 Aharon Baraka, *The Judge in a Democracy*, trad. Bi Hong-hai (Law Press, 2011), 17.

8 *Ltd. vs. Beijing Qihoo Technology Co.,* Beijing Baidu FMCT no. 2668 (Network Technology Co., Ltd. Case of unfair competition dispute (violation of robots protocol), (2013).

9 *Baidu Online Network Technology (Beijing) Co., Ltd v. Beijing Qihoo Technology Co., Ltd.* (Beijing High Court Civil Judgment (2013) Gao Min Zhong Zi no. 2352)

10 Xue Jun: Question "the principle of no interference in case of non-public necessity," *Electronics Intellectual Property*, (2015): 66-70.

11 The so-called typed features of behavior refer to the typical characteristics of a behavior reflected on the subject, object, subjectivity and objectivity which are the four constituent elements of a behavior. Constituent elements of unfair competition are commonly the following: the subject is the participant of various market trade operations; objectivity is the behavior which violates the principle of good faith or generally accepted business ethics; the perpetrator is subjectively fault; the object of the infringement is the interest of the operator, the interest of the customer and the public interest of the society. *See* Wang Xianlin, *Competition Law*, (China Renmin University Press, 2006), 96-98.

12 The so-called performance competition refers to the performance of their goods or services at competitive prices or to start competition of their own business activities, also known as the effectiveness competition. *See* Fan Chang-jun, *A study of German Anti-Unfair Competition Law*, (Law Press China, 2010), 114-115.

13 *Qihoo vs. Tencent of "QQ guards*, civil judgment of CF no. 5 (the Supreme People's Court. 2013).

14 Shandong Province Higher People's Court, the civil judgment of LCSF №5-2.

15 Xi Xiao-ming, Vice President of Supreme People's Court, in the forum of national IPR trial courts (28 November, 2011).

16 The Beijing First Intermediate People's Court, the civil judgment of FICF №3283. (2014).

17 Paris Convention for the Protection of Industrial Property, September 28, 1979, Article 10.bis.

18 The Supreme People's Court: "Some advices in consideration of full trial function of intellectual property, promotion of development and prosperity of socialist culture, promotion of the coordinated and autonomy development of economic", Article 24.

19 The Supreme People's Court, the civil judgment of CTF № 1065. (2013).

20 The Supreme People's Court, the civil judgment of CTF № 5 (2013) and The Beijing First Intermediate People's Court, the civil judgment of FICF № 2668. (2013).

21 The Supreme People's Court, the civil judgment of CTF № 5. (2013).

22 The Beijing First Intermediate People's Court, the civil judgment of FICF № 3283. (2013).

23 The Supreme People's Court, civil judgment of CTF № 4. (2013),

24 *Id.*

25 For specific application of this method *see* Huang Kun, "Economic analysis of the anti-monopoly review," *Research on Economics and Management,* no. 11*,* (2014): 87-97.

26 Herbert Hovenkamp, *The antitrust enterprise: principle and execution*, trad. Wu XU-liang (University of Finance & Economics Press, 2011), 48.

27 For price-related method of analysis *see* Peter Davis and Eliana Garcés, *Quantitative Techniques for Competition and Antitrust Analysis*, trad. Zhou De-fa. (China Renmin University Press, 2013), 139.

The 3Q case and the abuse of dominance analysis under China's Anti-Monopoly Law

By YONG Huang & XIN Zhang [1]

On March 20, 2013, the Higher People's Court of Guangdong Province gave its judgment on the case of abuse of market dominance of *Beijing Qihoo Technology Co., Ltd. ("Qihoo") vs. Tencent Technology (Shenzhen) Co., Ltd. and Shenzhen Tencent Computer System Co., Ltd.* (collectively referred to as "Tencent") and dismissed all the plaintiff's claims. On October 8, 2014, the Supreme People's Court made a second trial on the case and held that in the first instance judgment the facts ascertained were basically true, the application of law was correct and the trial result was appropriate, thereby it judged to reject the appeal and maintained the original verdict.

Anti-Monopoly Law of the People's Republic of China took effect and began to be implemented on August 1, 2008. *Qihoo vs. Tencent* monopoly dispute is the first case of abuse of market dominance in antitrust civil litigation, also the most notable case in the field. This case was ruled by the highest courts so far in the antitrust civil disputes, the court of first instance was the Higher People's Court of Guangdong Province and the judgment on appeal was made by the Supreme People's Court with the vice president of the Supreme People's Court as presiding judge. The analytical method and logic applied by the first instance court and the appeal court in the proceedings as well as the application of the Anti-Monopoly Law and determination of specific legal points embodied in the judgment will have important guidance, significance and profound influence. Meanwhile, this case was heard and judged publicly to the highest degree so far with part of the contents of the trial broadcasted on live by television and other online media. The publicity embodied by the two courts during the proceedings is unprecedented, which in turn helps, on the one hand, to further develop the Chinese concept and culture of competition and, on the other hand, provides guidance for potential plaintiffs and defendants in civil litigation in the future.

Both the plaintiff and the defendant of this case are two of the most influential Internet industry companies in China. The antitrust dispute between them caused wide and hot debate at home and abroad inside and outside the industry. Two trial courts faced enormous challenges on aspects such as marked definition, competition analysis and legal defense due to Internet industry's characteristics of short development history, strong competitive dynamics and involvement of complex and novel issues such as innovation and high tech. This case involved multiple market segments and multiple behaviors. Both parties argued for their own opinion and hired economists to support their claims that increased the complexity of the case. The legislation of China's Anti-Monopoly Law has been in forced for 13 years and its main provisions are formed on the base of relevant mature legislations and enforcement policies from the United States and Europe as well as a comparative study of Chinese legal system. The Anti-Monopoly Law covers the main areas of competition law in the structure with provisions expressed in principle, while in civil litigation practice there are no precedents for further reference. This requires, on the one hand, that the court as law enforcement party, and the litigants and lawyers as the counterparts in antitrust civil litigation, apply the Anti-Monopoly Law strictly, and on the other hand, to take full advantage of competitive harm theory to achieve the purposes and objectives of the Anti-Monopoly Law and civil litigation. Accurately grasping legal points and proposing relevant ideas are crucial.

Qihoo, the plaintiff of the case, claimed that Tencent, the defendant of the case, abused its dominant market position which involved 3 legal points of the Anti-Monopoly Law: firstly, whether the defendant has dominant market position in the relevant market; secondly, whether the defendant conducted abuse behavior; thirdly, whether the defendant has any contestable situation. The plaintiff respectively proposed its claims with regard to the aforementioned issues and provided the corresponding evidence; and the defendant's litigation strategy mainly was to refute the plaintiff's claims point to point and to raise a plea at the same time. During the trial of the first instance and the second instance, the courts analyzed and sorted out the claims and defenses raised by the parties as well as both parties' evidence to identify the contents with significance under the Anti-Monopoly Law. Just on the text of the verdict, the first instance verdict was over forty-four thousand words, and the second instance verdict up to over seventy-four thousand words with the reasoning and argument section more than thirty thousand words. These huge data not only suggests the courts' ability and attitude to undertake professional analysis on antitrust cases but also fully explains the complexity of the case.

As noted above, the period of China's Anti-Monopoly legislation and enforcement is short and the relevant system has not really formed. For the court, this dispute occurred in the Internet and high-tech field involving worldwide difficulty of innovation, and the determination of market dominance and the identification of abuse behavior that must be resolved in abuse cases involve complex market and economic analysis with strong specialty and considerable difficulty. During the trial course of the case, the judge read the analysis report submitted by bilateral expert witnesses including foreign economists, heard expert testimony and the testimony and debate on the economics research results of the parties, and analyzed and commented on such testimony and debate in the verdict and made professional judgment on substantive issues.

First of all, in the determination of Tencent's market dominance, the Supreme People's Court returned to the essence of market dominance, integrating relevant factors and investigating whether Tencent, under the existing conditions of competition, has the ability to increase service price, reduce the quality of service, hinder market entry and delay innovation. To do so, the Supreme People's Court referred to the international influential competition law precedent and competition harm theory, in addition to the evidence and claim on Tencent's market share submitted by both parties. This involved the trade-off between competition effectiveness and efficiency, reflecting the Court's trial thought of not being bound by theory but putting more emphasis on the actual state of the market.

All along, the competition law theorists have hold questioning attitude to the views of market share as the only standard for enterprises' market dominance. Sullivan and Grimes points out in the discussion of market control and market share:

> **Enterprises with large market share might have a small amount of market control, while enterprises with small market share might have greater market control. For example, if the market with low barriers to entry and the company's products are often replaced by other market products, the market control of a company even with 90 percent market share is quite limited.[2]**

Supreme People's Court's consideration on market share and other factors in the trial coincide with the theoretical developments. Such considerations have an important significance and value in changing, rapidly growing Internet industry monopoly disputes. This is because in such industry the determination of an enterprise's market dominance only based on its market share often goes awry. Dynamic characteristics of the competition in the market involved, the variability of competitive factors and the variability rate not only make market share figures show dynamic characteristics, but also may fail to reflect the market forces and the market positions of enterprises. Aware of this, the Supreme People's Court strengthened the intensity and depth of the analysis on other relevant factors. For example, on the analysis of market entry, referring to the discussion on *Microsoft/Skype*[3] case by European Commission, the Supreme People's Court finally reached its conclusion after deep and empirical analysis on issues such as "customer stickiness" and network effects based on case facts and lots of research data.

Secondly, the verdicts of the two courts took fully into account the characteristics of the Internet industry. As described above, compared to other industries especially traditional industries, the Internet industry has distinctive features such as more innovation, a highly dynamic environment and continuous evolution, which will inevitably lead to its competitive factors changing rapidly. In traditional industries, price is an indicator reflecting competitive dynamics and dynamic level and also the key point for law enforcement agencies to consider and analyze. In the Internet industry, however, operators' online products are often for free, and even with consumer subsidies (such as "Didi taxi" and "Kuaidadi taxi" software operators in the initial market launch of their software had spent a lot of costs of subsidize the users in order to seize market share). As a result, prices lost its function as market force indicators in cases involving the Internet industry. In addition, competition in the Internet industry also shows significant cross-border competition feature. Although operators' core business may be different or even belongs to different fields, due to online provision of their products and/or services operators may have competitive relationship. In this case, for example, one of the parties provides instant communication products and services, the other provides solutions in computer security field. According to the characteristics of Internet industry, the courts chose to incorporate an industry professional analysis, combine industrial analysis with economics analysis, consider the platform competition theory in the Internet industry and fully explain and demonstrate such theory in the verdict so that the final outcome of the trial truly reflected the actual state of competition on the Internet.

Thirdly, in the trial of this case, in addition to the application of the provisions and analytical thought of abuse of market dominance under the Anti-Monopoly Law, the courts dealt with the particularity of the case that provided a viable solution for future antitrust judicial practice. For instance, during the trial of the second instance, with regard to both parties' claims on the content of the first instance verdict, the Supreme People's Court pointed out that the boundary of the relevant market in this case may blur and the definition of the relevant market was the tool not purpose for assessing operator's market power and competition effect of the alleged monopolistic behavior. Thus, the Supreme People's Court did not obsess with the boundary issue of the relevant market, it fully evaluated enterprise's market power and the anti-competition effect of the accused behavior based on the detailed analysis of the actual and potential substitutable products with the definition of relevant market as evidence, and finally reached the conclusion that fitted with the actual state of the market. Such practice coincided with the direction where international antitrust enforcement thoughts and development are progressing. For example, the new version of the Horizontal Merger Guidelines responds to the new requirements for competitive analysis due to the new changes in the market today.[4] It clearly points out that the relevant market does not need to have a clear boundary, reduces the emphasis on the relevant market and market concentration, and strengthens the analysis of harm to competition.

It should be noted that the courts' process of definition of the relevant market in this case has distinct specific case characteristics that should neither be construed as a principle or rule, nor be applied rigidly in future cases. Furthermore, it should not be misread that the definition of the relevant market is becoming dispensable. The trial thought of combining law principle and rules with the industry involved and the individual case is in favor of the conclusion of judgment truly reflecting the actual state of competition in the industry. However, if the methodology is rigidly construed and applied to a specific case, we will deviate from the nature and objectives of Anti-Monopoly Law enforcement. Take the definition of the relevant market for instance, in most traditional industries, the relevant market and market share are still important indicators reflecting enterprise's market power and the competition effect of its behavior. In an antitrust lawsuit, even if the parties have direct evidence to prove the effect on competition of the alleged conduct, the analysis of the definition of the relevant market and market share are still indispensable.

The actual state of competition in the Internet industry has great confusion. The competitive structure is usually embodied as oligarchs split state; and in practice, "rapidly evolving technology can sometimes render market power transient in high-tech markets,"[5] the intensity of competition in the industry and the cruelty of competition means may also be unmatched by traditional industries. Internationally, the actual complex state of competition in this industry derived from theory of competition specifically applicable for the industry. Even the application and development of this competition theory often becomes the object of questioning and controversy. The meaning of the judgment of the Supreme People's Court is that it specifies that like other economic evidence, the determination of the relevant market and market share is just one of the factors for determining market dominance which complies with the requirement of the Anti-Monopoly Law. Meanwhile, for the Internet industry, highly dynamic due to technological innovation, its boundary of the relevant market is inevitably blurry, the comprehensive consideration of all factors affecting competition is very important.

The Anti-Monopoly Law and its enforcement in China are still new things especially in the early stage of Anti-Monopoly Law enforcement and relevant judicial practice has great room for development. *Qihoo vs. Tencent* as well as *Ruibang Yonghe vs. Johnson & Johnson* ¾ as the first cases of monopolistic agreement ¾ laid a solid foundation for the development of judicial practice. The reasoning of the court, combining theory and practice, verified by experience and empirical judgment ¾ as well as the court's attitude of flexibility on issues of specific case characteristics and verification and supporting its conclusion through various channels ¾ reflect the combination of Anti-Monopoly Law and reasoning to prevent the judicial practice from deviating from the basic objectives of the law and becoming a tool of rigid application. In addition, China's Anti-Monopoly Law is applied by both its enforcement and court of justice. Justice has great significant implications for Anti-Monopoly Law enforcement. According to the State Council's authorization, three administrative authorities are responsible for Anti-Monopoly Law enforcement, and in the more than six years of the implementation of the Anti-Monopoly Law they have dealt with a large number of cases with some influential case included. The clarifying of some principles and rules in judicial practice could become an important reference for Anti-Monopoly Law enforcement. The trial thought and attitude will enhance the transparency of Anti-Monopoly Law enforcement and will promote a better interaction between Anti-Monopoly Law enforcement and court of justice.

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2 Lawrence A. Sullivan and Warren S. Grimes, *The law of Antitrust: an integrated handbook*, (Minnesota: Thomson/West, 2006), 64.

3 Commission Decision C (2011) 7279 declaring the concentration between undertakings involving the acquisition of Skype by Microsoft to be compatible with the internal market and the Agreement on the European Economic Area (EEA) Case COMP/M.6281 – Microsoft/Skype.

4 Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission, August 19, 2010, http://www.justice.gov/sites/default/files/atr/legacy/2010/08/19/hmg-2010.pdf.

5 Speech by the deputy minister of the U.S. Department of Justice, Renata Hesse on January 22, 2014, "At the Intersection of Antitrust & High-Tech: Opportunities for Constructive Engagement," http://www.justice.gov/atr/public/speeches/303152.pdf.

Relevant Market Definition and Market Dominance Identification in 3Q War

By HUANG Wei [1] & HAN Guizhen [2]

I. INTRODUCTION

The appellate dispute between Qihoo 360 Technology Co. Ltd. ("Qihoo") and Tencent Holdings Limited ("Tencent") regarding Tencent's allegedly abuse of market dominance was the first antitrust case ever tried by the China Supreme People's Court ("CSPC") and was also the longest-ever hearing held by CSPC so far, lasting for over 28 hours. CSPC issued a 113-page, 74,000-character, "textbook-like" ruling ("3Q War final ruling"). In this judgment, CSPC made a pithy exposition on relevant market definition, market dominance identification, and the relationship between these two. As the attorneys representing Tencent in the appeal and in the hearing, we would like to, incorporating both domestic and overseas relevant findings, provide an elaboration and necessary summarization on the following issues referred to in this ruling: the allocation of evidence adducing burden in relevant market definition, the role of "Hypothetical Monopolist Test" ("HMT") in relevant market definition, the "Most and Important Rule" necessarily applied in Substitution Analysis, and the accurate view on the role of market share in finding market dominance from a dynamic competition perspective.

II. RELEVANT MARKET DEFINITION ISSUES

A. Finding Abuse of Market Dominance Solely Based on Direct Evidence without a Clear Delineation of Relevant Market Only Applies in Exceptional Situations, Which Shall Not Be Regarded as Universal

In accordance with Article 2 of the "Guidelines on Relevant Market Definition" ("Guidelines") issued by the Anti-Monopoly Committee of State Council, relevant market definition is generally the starting point to analyze competition activities, and is an important step in antitrust enforcement. In abuse of dominance cases, relevant market definition is generally considered as the beginning and the prerequisite of finding whether a business operator holds a dominant position in the relevant market and whether its conducts constitute abuse of market dominance. In "3Q War final ruling," CSPC raised a pivotal point on defining relevant market as:

> **In the trials of abuse of market dominance cases, defining relevant market is the tool to evaluate the business operator's market power and the impact casted by the alleged monopolistic conducts to competition, however, defining relevant market itself is not the goal. Even without a clear delineation of relevant market, a business operator's market position and competitive effects of the accused conducts could be evaluated through direct evidences showing the precluding or hindering effects rendered to competition. Hence, not every abuse of market dominance case needs an explicitly and clearly defined relevant market.[3]**

CSPC's aforementioned holding in such a significant case, "the first Internet anti-monopoly case in China," raised heated discussion on necessity of relevant market definition in all sectors of society. As such, an accurate comprehension of relevant market definition in cases of market dominance will directly affect the fundamental litigation strategies and trial logic in future cases. As scholar Mr. Liu Xu pointed out in his article posted after the first trial:

> **In face of the disputes on relevant market definition, relevant experiences from German and the European Union could be taken as reference, i.e. in the relevant market where instant messaging software QQ belongs to, Tencent's market dominance can be assessed and concluded through the structural characteristics of the business operator and the suspected conducts exercised irrespective of competitive constraints.[4]**

Furthermore, the "Unilateral Effects Theory" emerged in 1980s in the United States also raised certain doubts on the function of market definition. "Unilateral Effect Theory" believes that a merger between firms selling differentiated products may enable the merged firm to profitably raise the price above competitive level without losing clients. Thus, as long as the merged entity has diminished market competition through its unilateral conducts, it could be concluded against the merger without defining the market.[5]

Back to "3Q War final ruling" itself, CSPC discussed relevant market definition issues under the first specific issue on "whether the first trial court's omission to define a definite market constitutes failure in finding basic facts" in the first focus of dispute "how to define the relevant market in this case." The CSPC's basic perspective of analysis rests on whether the people's court is obligated to explicitly and precisely define the relevant market during the trial in abuse of market dominance cases. Hence, CSPC's conclusion that "not all cases of abuse of market dominance require an explicitly and precisely defined relevant market," is addressing the people's court ruling on abuse of dominance cases, not the plaintiff' obligations.

CSPC's above holding aims to clarify the responsibilities and role of people's court in ruling on abuse of dominance cases, and thus held that first trial court's omission to define a clear boundary of relevant product market did not amount to failure to achieve a clear basic facts finding. In the meantime, CSPC followed the traditional analytical approach of ruling on abuse of market dominance cases. That is, firstly it defined the relevant market in this case as the instant messaging service market in Mainland China; secondly based on this definition, CSPC analyzed whether Tencent held a dominant position in this market and whether its conducts constituted abuse of market dominance. As seen from the above, even if CSPC clearly pointed out the obscure nature of relevant market boundary in this case, it still strived to define the relevant market in this case. As such, CSPC is particularly prudent "to assess the accused business operator's market position and the potential market effects of the alleged monopolistic conducts based on direct evidence, demonstrating the effect of precluding or hindering competition." Except for extremely special situations, market dominance shall not be directly found without defining relevant market.

B. Plaintiff Shall Bear the Burden of Proof to Define Relevant Market

CSPC has clearly pointed out in its "3Q War final ruling" that, "in abuse of market dominance cases, the party claiming others of abusing market dominance shall bear the burden of proof for defining the relevant market."[6] Pursuant to Article 8 of Provisions of the Supreme People's Court on Several Issues Concerning the Application of Law in the Trial of Civil cases Arising from Monopolistic Conducts:

> **Where the monopolistic act sued falls under any of the acts of abusing market dominant position as prescribed under Paragraph 1 of Article 17 of the Anti-Monopoly Law ("AML"), the plaintiff shall bear the burden of proof to show that the defendant is dominant in the relevant market and has abused its market dominant position.**

Thus, in abuse of market dominance cases, plaintiff assumes the burden to adduce evidence to define relevant market. Where plaintiff is intended to accuse others of abusing market dominance, it shall delineate the relevant market boundaries clearly. If plaintiff failed to perform an explicit and precise market definition, it may assume unfavorable results due to failure of adducing supporting evidence. As commonly known, relevant market definition is not an easy task, demanding massive evidence, fundamental data, industry reports and economic analysis, sometimes even large scale investigations. Doubtlessly, this process is extremely time and effort demanding. Should the burden of proof for relevant market be assigned to people's court, it is not only groundless in law, but it is also inefficient and unreasonable. Imagine, if a plaintiff is allowed to launch an abuse of market dominance lawsuit with an arbitrarily defined relevant market or even a probable or vague relevant market definition, and shifts the burden of prudently defining relevant market to the people's court, it will undoubtedly waste judicial resources, and may also lead to random or wanton attacks launched by entities against their competitors wielding such abuse of market dominance lawsuits. As such, the healthy market competition will be harmed deeply.

Though U.S. academics has been gradually questioning the functions of relevant market definition, the courts still hold on to the plaintiff's responsibility of defining a relevant market in "monopolization" or "attempted monopolization" cases, and would reject a case that fails to define relevant market correctly. For instance, in *Carl E. Person v. Google Inc.*, the U.S. District Court for the Northern District of California, San Jose Division ("San Jose Division Court") took the view that "in order to make out a claim for attempted monopolization or monopolization, a plaintiff must define the relevant market[7]… [t]he 'search advertising market' thus is too narrow to constitute a relevant market for antitrust purpose."[8] Hence, San Jose Division Court dismissed the monopolization and attempted monopolization claims presented in the first amended complaint.[9] In appeal, the U.S. Court of Appeals for the Ninth Circuit affirmed and agreed with San Jose Division Court's opinions.

C. The Basic Approach for Defining Relevant Market is Still Substitution Analysis, and HMT Shall Be Regarded as Necessarily Complementary

CSPC has clearly held in "3Q War final ruling" that, "as an analytical approach for defining relevant market, HMT is universally applicable."[10] This holding has led to divided understandings among antitrust practitioners and scholars. We take the view that, under the Guidelines and the practical application of HMT by CSPC in "3Q War final ruling," HMT as a relevant market definition method, does not have universal applicability. It shall only be applied when "the market scope of business operators is unclear or hard to ascertain." CSPC's holding of the universal applicability of HMT mainly refers to its analytical function, which could be applied to the complimentary side of a two-sided Internet market as well. The differentiation in market feature and competition factor would not hinder the application of HMT.

First, in accordance with Article 4 of Guidelines, "the definition of a relevant market shall mainly be based on the consumers' demand analysis. When competitive constraints on operators' acts resulting from supply-side substitution are similar to those resulting from demand-side substitution, supply-side substitution shall also be taken into account." Article

7 of Guidelines, summarizing approaches to define relevant market, stipulates:

> **There is no exclusive method for defining a relevant market. In the antitrust law enforcement practice, different methods may to be used in accordance with the actual situation. In defining a relevant market, demand-side substitution analysis may be carried out according to factors such as product characteristics, intended use, pricing pattern, and supply-side substitution may be carried out if necessary. If the market scope within which operators compete with each other is vague or undefined, the relevant market may be defined on the basis of the analytical theory of "Hypothetical Monopolist Test" (see Article 10 hereof).**

Article 10 further specifies "[t]he hypothetical monopolist test is an analytical theory for defining a relevant market. It can help resolve any uncertainty which is likely to occur in the definition of a relevant market." Therefore, according to China's current regulations on HMT, this method is not a general way or a main approach for market definition. HMT may only be used as an approach to resolve uncertainties in market definition when the relevant market boundary is unclear or hard to determine.

Second, substitution analysis should be consistently applied in relevant market definition, where the demand-side substitution should be the primary approach and supply-side substitution the complementary. Such view can be seconded by the Shanghai High People's Court's ruling of the vertical monopoly agreement disputes between Johnson & Johnson and Beijing Ruibang. Shanghai High People's Court pointed out in its judgment that "HMT is a quantitative measurement based on the underlying principle of substitution analysis. Substitution analysis is still essential. If relevant market could be clearly defined by employing demand-side substitution and supply-side substitution analysis, there is no need to employ HMT anymore."[11] Notably, CPSC did not apply HMT formally in its 3Q War final ruling. CSPC referred to HMT only in its analysis of mobile text, email and geographic market. For instance, "if an instant messaging monopolist lowers the quality of instant messaging to a certain extent, it is unlikely for adequate users to switch to paid mobile text as substitute." Thus, CSPC actually applied the demand-side substitution and supply-side substitution analysis as main approach to define relevant market. In case that substitution analysis could clearly delineate relevant market in the instant case, HMT is no longer needed.

D. Substitution Analysis Shall Hold on to "Majority and Important" Rule

Demand-side substitution analysis is the primary approach for defining relevant market. Most of the other methods are improvements or particularizations to demand substitution analysis. In defining relevant market, we shall first consider how to accurately comprehend and apply demand substitution analysis. In 3Q War antitrust suit, the involved instant messaging products simultaneously differentiated from and overlapped with Weibo, SNS, email, mobile text in respect of attributes and usage. To accurately apply demand-side substitution analysis in order to achieve a clearly delineated relevant market boundary is not an easy task, which also constitute one of the focuses of disputes in the appeal. We take the view that CSPC established "majority and important rule" under demand-side substitution analysis in its application of demand-side substitution analysis to define relevant market, i.e. to analyze whether there are adequate users who would regard a specific good as alternative goods or regard a certain territory as alternative geography territory based on the core demand of majority users and from the perspective of the key attributes of goods.

1. Demand-side Substitution should be Analyzed on the Demand of the Majority of Users

As specified in the Guidelines, demand-side substitution determines the substitutability of different products from the perspective of consumers based on factors such as their needs regarding functionality and usage, recognition of quality, affordability of prices, difficulty in accessing the products, etc. In antitrust litigation and enforcement, to determine consumers and their scope would directly influence the boundaries of relevant market. Demand-side substitution analysis should start with the users of targeted products, i.e. users demanding the products subject to accused monopolistic conducts. As further clarified in CSPC's 3Q War final ruling, relevant market definition should be based on the key characteristics and core functionality of the targeted products demanded by the majority of users.

In 3Q War final ruling, CSPC firstly started with the targeted products by pointing out that the Tencent QQ instant messaging ("IM") service related to the accused monopolistic conduct is an integrated IM service, which is capable of proving three types of communication functions (text, audio, and video). In analyzing whether the non-integrated IM service should be included in the relevant product market in this case, CSPC underlined that text communication is the most frequently used function by 93.2 percent of users after comparing the integrated and the non-integrated IM service in respect of product characteristics, accessibility and functionality. Thus, text communication function is an important function favored by most users. As such, it concluded that non-integrated IM service is a close substitute of most integrated IM services. The relevant market definition in this case, was held to be Mainland China. Although tens of millions of users all over the world were affected by Tencent's "choose one from two", CSPC held most users demanding Tencent QQ were in mainland China. Hence, it inspected the relevant geographical market from the targeted Mainland China IM service market, and concluded the relevant geographical market of 3Q War antitrust case as the Mainland China market.

2. Relevant Product Analysis should be based on Most Users' Preference and Options in respect to Product Characteristics and Functionality.

The substitutability of different products should be determined from the perspective of consumers; the majority users' preferences and options towards product characteristics and functionalities should be concerned when comparing product characteristics, accessibility, functionality, etc., in order to determine whether the majority of users regard a certain product as a close substitute to the targeted product.

In the 3Q War final ruling, the CSPC, in addition to analyzing the text communication preference of most users in analyzing integrated and non-integrated IM service, also determined the issue of whether SNS and Weibo should be included as part of the relevant product market for this case. CSPC ultimately concluded, based on user statistics reports issued by China Internet Network Information Center ("CNNIC") and iResearch Consultancy, that for the majority of users, IM service, SNS, and Weibo served different purposes. SNS and Weibo users were found to have a broader purpose, focusing more on social functions such as friend connection, information sharing, profile demonstration, and friendship development, etc.; SNS and Weibo are more notable by their social nature. Therefore, from the perspective of the majority of users' demands, the relationship between IM service and SNS or Weibo was held to be complementary rather than substitutive.

3. Product Characteristics and Pivotal Functions Are Key Criteria for Determining the Close Substitutability between Products

The attributes and functions of different products are not necessarily and completely different. The products included in the considerations to determine the scope of the relevant market must have some overlaps in respect of attributes, functions and usages. Hence, in assessing the substitutability between different products, the essential and pivotal attributes should be distinguished from the non-essentials and should be the focus of the analysis.

In 3Q War final ruling, CSPC recognized that though SNS and Weibo shared some common attributes with IM services, (e.g., Internet-based, online-notice of status, user profile management, free service, etc.) they still differ significantly in important attributes. When analyzing functions and purposes of SNS, Weibo and IM, the first instance court incorrectly overlooked the key difference between the former two groups of open communication, targeting mass users, and IM service' focus on bilateral private communication or internal communication among small groups. Thus, the court overstated the social nature of IM service. In analyzing whether mobile text messaging, emails should be included in the relevant market definition, CSPC considered that "more importantly, IM service is free, while mobile text messaging is paid service"; "email differs in key functions and attributes with IM services, email does not have the instant nature of communication, neither does it have the function of notifying user online status, while the instant nature of communication is the most essential and most-focused function of IM service by users."[12]

In determining whether the relevant product market should be defined as Internet application platforms, CSPC gave an adequate consideration on the integrated nature of different Internet application platforms, i.e. almost all of them provide comprehensive Internet service and overlapped with each other to some extent. However, "the key issue is whether the mutual competition between Internet platforms on user attentions and advertisers have completely surpassed the boundaries decided by product or service attributes and imposed sufficiently strong competitive constraints on business operators."[13] CSPC pointed out "the competition between Internet platforms on user attentions and advertisers are based on the core products or services they provide."[14] The core products or services provided by these Internet platforms differs significantly in natures, characteristics, functions, usages, etc. These differences lead to the possible distinction in the main user groups and advertisers they may compete for, which ultimately determined the relatively big difference in business models, targeted user groups, subsequent market products, etc.

How to accurately apply demand-side substitution analysis is a key and complicated issue in antitrust enforcement and litigation. CSPC had an adequate application of demand substitution analysis in its 3Q War final ruling, and established an important analytical approach in demand-side substitution analysis— "most and important" rule. This rule focuses on the most users' preferences and options on relevant products' core functions, and grounds on the core and pivotal attributes of products to analyze the substitutability between different products. This rule will undoubtedly have an important and far-reaching impact on future antitrust practices.

III. IN INTERNET DOMAIN, A BUSINESS OPERATOR'S MARKET DOMINANT POSITION SHALL NOT BE DECIDED SOLELY BASED ON ITS MARKET SHARE IN RELEVANT MARKET

In the traditional cost-price oriented competitive market, a business operator's dominant power and position in the relevant market can be reflected through quantitative and visual market share data, and this kind of quantitative market power data provides important guidance to determine whether this business operator possesses a market dominant position. However, market share is only a preliminary standard, if at all, but not a decisive standard in market dominance evaluation. As the case may be, several other specific elements shall also be taken into consideration. For example, stability of a certain market share in the relevant market, a comparison between business operators' market shares in the same relevant market, the business operator's pricing behavior, the intellectual advantage, the diversity of the relevant products, etc. In particular, attention shall be paid to the peculiarities and situations of competition in the relevant market, and core competition factors for the business operators.

More generally, even if a business operator possesses a market share lower than the specific data stipulated by law, the possibility of holding a market dominant position in the relevant market cannot be simply excluded. As stated by Mr. Lars-Hendrik Röller from the European Commission, Directorate General for Competition, in "China Antitrust Law Seminar" in 2005:

> **According to European Union laws and judicial precedent, if a business operator possesses 50 percent or more market share in relevant market, market dominance will be presumed. However, based on our current law enforcement practices, for some specific cases, a business operator possessing less than 50 percent market share in relevant market can still be found holding market dominance. Therefore, when we were having internal discussion of the trends of policies, for market dominance evaluation, we believe that we would lay less stress on market share in future.[15]**

On the other hand, if a business operator possesses a market share that is higher than the threshold stipulated by law, it would not necessarily be found as having market dominance, and analysis should be made on a case-by-case basis. As mentioned by Mr. Makan Delrahim from the U.S. Department of Justice in "China Antitrust Law Seminar" in 2005:

> **In market power evaluation, if a business operator's possession of market share reaches or surpasses 60 percent or 70 percent in relevant market, U.S. law executors would evaluate whether it holds market dominance. Nevertheless, even if a business operator has more than 70 percent market share in relevant market, market dominant power cannot be easily presumed, market situations shall also be carefully analyzed.[16]**

In 3Q War antitrust lawsuit, Tencent's alleged abuse of market dominance occurred in emerging Chinese Internet industry, in which the foundation Internet service is free. Therefore, Internet service providers compete with each other more on aspects like quality, service maintenance, and innovation, rather than price. CSPC pointed out in the 3Q War final ruling that,

> **The competition in Internet environment is highly dynamic, therefore the boundary of relevant market is far less clear than that of in traditional industry. Consequently, the indicative function of market share of a specific business operator shall not be overestimated, and more attention should be paid to the concrete facts and evidence demonstrating the difficulties of entry barriers, the behaviors of business operators, and the impacts on market competition, that would be helpful for the evaluation of a business operator's market dominance power in relevant market; in instant communication domain, business operators keep creatively competing with each other to provide better quality, services, user experience, and the innovation period for such products is relatively short.**

Thus, in Internet industry, market share itself cannot accurately reflect the dominant power and position of a business operator in a competitive relevant market. Even though the CSPC concluded that for the market for both personal computer and cell phones instant messaging service, Tencent possessed more than 80 percent market share, the CSPC still ruled that Tencent did not possess market dominant position in the aforementioned markets. This decision was made after evaluating the difficulty for other business operators to enter in the relevant market, reviewing Tencent's market behaviors, considering the competition constraints developed through Internet platform competition and in light of the highly dynamic and innovative characteristics of the Internet industry.

While studying European and American antitrust law enforcement practices, it is seen that even in the European Union, where the law enforcement standard is comparably stricter, the understanding of the European Commission and European courts regarding evaluation of market dominance in relevant market on the basis of market share of the business operator have been constantly evolving, and have been increasingly cautious. In 2011, as the European Commission pointed out in the opinion decision for the proposed Microsoft/Skype concentration,

> **Market shares only provide a limited indication of competitive strength in the consumer communications services markets. Consumer communications services are a nascent and dynamic sector and market shares can change quickly within a short period of time...market shares are not the best proxy to evaluate the market power of providers of consumer communications services and they only give a preliminary indication of the competitive situation in these dynamic markets.[17]**

Accordingly, the European Commission believed that the concentration would not constrain competition even though, after Microsoft's acquisition, the market share in the subdomain video call would exceed 80-90 percent. When the case was appealed, the General Court of the European Union stated in the judgment:

> **The consumer communications sector is a recent and fast growing sector which is characterized by short innovation cycles in which large market shares may turn out to be ephemeral. In such a dynamic context, high market shares are not necessarily indicative of market power and, therefore, of lasting damage to competition which Regulation No 139/2004[18] seeks to prevent.[19]**

In some U.S. antitrust lawsuits targeting relevant Internet companies, it is observed that market dominance can be found solely based on market shares in the relevant market. In *American Online v. GreatDeals.Net et al*, the Judge of the U.S. District Court for the Eastern District of Virginia, Alexandria Division pointed out that, "to determine whether there is a high probability of success in monopolizing the market, courts often consider the relevant market and a participant's ability to lessen or destroy competition in that market."[20] In *Emigra Group LLC v. Fragomen, Del Rey, Bernsen & Loewy, LLP, et al*, the Judge of the U.S. District Court, S.D. New York stated that, "market power can persist only when entry barriers – market circumstances, governments, or the defendants – block rivals' entry or expansion. And the lack of significant entry barriers can defeat a monopolization claim, even in the fact of a defendant's high market share."[21]

IV. EPILOGUE

In order to apply and improve Chinese Anti-Monopoly Law, in addition to efficient and effective investigations performed by enforcement agencies, the people's court also needs to professionally and prudently administer the law and develop AML judicial practices. Only in this way can the development and improvement of Chinese AML be jointly promoted. In the 3Q War final ruling, CSPC expressed its opinions on identifying the relevant market and evaluating market dominance, specifically for the Internet industry. This 3Q War final ruling not only integrated experiences from Europe and America antitrust lawsuits, but it also fully considered and relied on Chinese development practice. Hence, CSPC rendered a proper ruling in accordance with Chinese antitrust enforcement practice. After this ruling, Chinese antitrust judicial litigation and enforcement investigation will be profoundly influenced.

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3 *Qihoo 360 v. Tencent*, Min San Zhong Zi No.4 (China Supreme People's Court. 2014).

4 Liu Xu, "Finding of Dominant Market Position in Qihoo v. Tencent," *Electronics Intellectual Property* 4, (2013): 30.

5 Ministry of Commerce Department of Treaty and Law & Shang Ming, *The Theory of Chinese Antitrust Law and Practice,* (Beijing: Peking University Press 2008), 164.

6 *See* Qihoo 360 v. Tencent, *supra* note 3

7 *Forsyth v. Humana, Inc.,* 114 F.3d 1467, 1476 (9th Cir.1997). *in Person v. Google*, *Inc.*, No. C 06-7297 JF (RS), 2007 U.S. Dist. LEXIS 47920, (N.D. Cal., June 25, 2007).

8 *Id.* at 15-16.

9 *Id.* at 3.

10 *See* Qihoo 360 v. Tencent *supra* note 3 at 77.

11 *Beijing Ruibang v. Johnson & Johnson,* Hu Gao Min San Zhi Zhong Zi No.63, 43 (Shanghai High People's Court. 2013).

12 *See* Qihoo 360 v. Tencent, *supra* note 3 at 88-89.

13 *See* Qihoo 360 v. Tencent, *supra* note 3 at 90.

14 *Id.*

15 Shang Ming, *Antitrust Regulations Towards Corporations' Abuse of Market Dominanc*e, (Beijing: Law Press China, 2007), 126.

16 *Id.* at 122 quoting speech given by Mr. Makan Delrahim of U.S. Department of Justice in "China Antitrust Law Seminar" in 2005, Beijing.

17 Commission Decision C(2011) 7279 declaring the concentration between undertakings involving the acquisition of Skype by Microsoft to be compatible with the internal market and the Agreement on the European Economic Area (EEA) (Case COMP/M.6281 – Microsoft/Skype)

18 Council Regulation (EC) No. 139/2004 of 20 January on the Control of Concentrations Between Undertakings, (2004) OJ L24/1

19 T-79/12, *Cisco Systems Inc. and Messagenet SpA v. European Commission*, at 69, December 11, 2013, not yet reported.

20 *Spectrum Sports, Inc. v. McQuillan*, No. 91-10, 506 U.S. 447 at 456) *in* A*merican Online, Inc. v. GreatDeals.Net*, No. 99-62-A, 49 F. Supp. 2d 851, 861 (E.D. Va 1999).
21 *Emigra Group LLC v. Fragomen*, No. 07 Civ. 10688 (LAK), 612 F. Supp. 2d 330, 362 (Southern District of New York. 2009).

The First Antitrust Decision By The Chinese Supreme People's Court Qihoo 360 Vs. Tencent

The Chinese Supreme People's Court issued its first antitrust judgment in Qihoo 360 v. Tencent on October 16, 2014. In affirming a lower court ruling in favor of defendant Tencent, the Court addressed the question of market definition and market power in the context of dynamic platform-based businesses in which products are provided for "free". It is one of the most influential cases in the 65-year history of the Supreme Court according to the People's Court Daily.

CPI gathered leading antitrust lawyers and economists to discuss the implications of the Tencent judgment for antitrust in China and for Internet-based cases in other jurisdictions. The webinar was held on 16 December 2014.

Professor D. Daniel Sokol moderated a discussion with Antonio Bavasso, Dr. David S. Evans, Willard Tom, and Dr. Vanessa Yanhua Zhang. Evans and Zhang, with Global Economics Group, advised Tencent and submitted testimonay to the Chinese Supreme People's Court. Bavasso is a partner at Allen & Overy in London and Will Tom is a partner at Morgan Lewis in Washington D.C. and former General Counsel of the US Federal Trade Commission. Danny Sokol teaches at University of Florida Law School and is Senior Of Counsel to Wilson Sonsini Goodrich & Rosati.

The following is a transcript of the webinar.

Daniel Sokol: Welcome to the CPI webinar, "The First Antitrust Decision by the Chinese Supreme People's Court, Qihoo 360 versus Tencent." I am Professor Daniel Sokol. With me are a number of excellent panelists who are going to provide analytical insights into this historic decision.

First we have David Evans, Chairman of the Global Economics Group. David has provided economic advice on a wide range of industries but has special expertise on platform based businesses, which some of us know of as two-sided markets. David currently teaches economics and antitrust at the University of Chicago Law School where he is a lecturer and at University College London where he is a visiting professor and is co-founder and co-director of the Jevons Institute.

Let me also add, David contributed a brilliant chapter to the Oxford Handbook of International Antitrust Economics, Volume 1 which is out as of this month which I edited. I encourage people to take a look at it for what was really a wonderful piece of scholarship and background.

Dr. Vanessa Yanhua Zhang specializes in economic analysis and competition policy at Global Economics Group, where she heads the China practice. Dr. Zhang has taught regulation and antitrust economics to graduate students at Renmin University of China. She also serves as the editor of the Asia Antitrust Column at Competition Policy International. Together, David and Vanessa worked as the economic consultants in this case for Tencent. Their insights as a result are highly appreciated.

Also joining us on the law side are two distinguished lawyers. The first is Antonio Bavasso. Antonio is co-head of the Global Antitrust Practice in Allen & Overy. He advises clients on all aspects of competition law, practicing primarily in London and Brussels. In addition to his work at the law firm, Antonio also teaches the EU competition law course at UCL, and along with David, is the co-founder and co-director of the Jevons Institute.

Joining us from the United States is Will Tom. Will is a partner in Morgan Lewis' antitrust practice in Washington, DC, and former General Counsel of the Federal Trade Commission. This is one of a number of senior positions that Will has held at both the Federal Trade Commission and the Department of Justice Antitrust Division. Over his career, Will has been very active on antitrust IP matters. Specific to China, Will was very active in the development of outreach efforts to China while at the FTC.

With those introductions, let me just note we have a historic case. There are a number of issues that we're going to discuss about abuse of dominance in China. We'll discuss platforms, high tech industries, economic analysis and reasoning by the court.

I think that maybe what we could do is start with Vanessa. Who are these companies?

00:03:46

Vanessa Zhang: Thank you, Danny. So let me give you a brief introduction of those two companies in this case. Tencent is the largest instant messaging software producer or provider and offers various free services. Those free services include the instant messaging platform, which also called QQ, Weibo, which is a micro-blogging platform, online games, online security software, social network services, search engine and e-commerce.

Tencent makes profits from selling advertising to companies that want to reach Tencent users, selling virtual products or items for its online gaming services, charging its users for the bundled SMS packages, providing mobile games and charging for other mobile value-added service such as the mobile books.

As its main product, QQ has 340 million monthly users in November 2010 and 452 million monthly users as of April 2013 according to iRresearch.

Let's turn to the other company, Qihoo 360. Qihoo is the largest Internet security software provider. And it also provides free services such as online and mobile security software, a web browser and a game platform with the games developed by third-party game developers.

Qihoo 360 makes profit from selling advertising and providing web game services. Its main product is called 360 Safeguard. It had 275 million monthly users in November 2010 and 444 million monthly users as of April 2013. So that's the basic background of the two companies. Danny.

Daniel Sokol: Thank you. Well, ultimately in order to have a decision we need to have a legal claim. Will, I wonder if you might walk us through what is the legal issue here? What's the allegation?

Will Tom: Put very simply, the war started when Qihoo publicly claimed that Tencent QQ instant messenger invaded users' privacy and configured its security software to block QQ. In response, Tencent called on users to make an either/or choice between QQ and Qihoo's 360 software, and announced that it would block users who have installed 360 from using QQ. It also bundled the default installation of its own security software with QQ upgrades.

Through governmental intervention, compatibility was quickly restored, but Qihoo sued Tencent under Article 17 of the Anti-Monopoly Law, claiming that the either/or choice made to users was an abuse of a dominant market position.

Daniel Sokol: We're going to get into the details in just a little bit. The question for those listening is as follows - what are the key ramifications for the decision for Chinese antitrust? David, I wonder if you could take a first stab at this?

David Evans: Thanks, Danny and thanks Will and Vanessa for that introduction. I think there are three important ramifications. None of them really have to do with the abuse of dominance claim, which I don't think anyone really took very seriously. The court probably could have just bounced the case based on just looking at some of the details of the claim and the effects.

So the importance of the decision is really on market definition and market power analysis and how the courts are approaching that. There are really three things.

First, the court adopted what I think is a very modern approach to market definition and the analysis of market power. It said that market definition, and I'm using my own words here, but I think it characterizes it pretty well, that the market definition is really a guide and that it isn't necessary to establish rigid boundaries in doing a market definition analysis. So it didn't get stuck in the rigid market definition approach that is still used in the European Union and it used to be pretty common in the US as well.

It also found related to that that market share is really just one metric for assessing monopoly power and a metric that actually ought to be used with considerable care. So the Chinese Supreme Court isn't going to obsess about market share statistics. And that makes the Chinese approach similar to the approach that many economists and antitrust scholars have advocated and that got incorporated into the 2010 DOJ/FTC merger guidelines. So that's the first point.

A second point is that the Chinese Supreme Court and the intermediate court recognized the importance of two-sided platforms, two-sided markets, in conducting a sound antitrust analysis. Interestingly they followed the approach that the ECJ more or less took in the recent Cartes Bancaires decision, and that's really that the two-sided platform issues should be dealt with in the analysis of market power and effects rather than in market definition. But nonetheless, they took two-sided platforms seriously and made it clear that that needed to be part of the analysis.

Here's third thing. You know you always like decisions where you won better than those where you didn't win and I obviously come from that bias. But if you read the decision, it's clear that in their very first case the Chinese Supreme Court is very comfortable dealing with advanced topics in antitrust. You know you can quibble with various things that they do, but I think overall the decision reflects a highly nuanced understanding of antitrust concepts. They were able to get into SSNIP test and hypothetical monopoly tests and all sorts of relatively advanced topics in antitrust. And, again, whether you agree with them or not, it does seem to be an impressive first showing for the court.

Daniel Sokol: Thank you, David. First of all, let me start by saying I agree with you entirely that this is not an easy first case. I think the Supreme People's Court really did a fine job. But we have legal experts from two other important jurisdictions and I thought maybe to get their thoughts. Antonio, you haven't had a chance to chime in yet. And I thought especially since David did bring up Commission cases and EC law more broadly, and given that you teach exactly these things in addition to practice it, I thought we would start with you.

Antonio Bavasso: Thanks, Danny. Yes. I think this judgment is extremely interesting. First of all, my high level reaction is that the Supreme Court went very deep, as David said, into the facts. I don't know if this is a function of the legal test of the Supreme Court is applying. Perhaps they have more leeway to do so under the standard that is applied in China. But it is impressive how detailed their analysis is about the economic evidence and how comfortable they seem to be to analyze and come to a view on advanced topics of antitrust economics.

Four high-level points that jump off at me about this judgment.

The first one is when you read the judgment and compare to the intermediate decision, they do appear to do market definition analysis which is fairly focused on a functional distinction between the products. And they explicitly say that the markets that business people refer to may provide clues, but cannot replace a rigorous relevant market analysis. I'm obviously looking at an English translation of the judgment.

But then, and this is my second point, having defined the market rather narrowly, they don't get stuck in that narrow market definition. Rather they do look at the question of dominance in a much more economically-minded way than what we are used to in many other jurisdictions. Therefore, as David said, they don't attribute an excessive importance to market shares, notwithstanding what appear to be some fairly constraining limits coming from the Chinese legislation about market shares. Effectively even though they look at dominance starting from a fairly narrow market definition they look also at the effect of the behavior and, most interestingly, they infer from the lack of effect that there is probably not a dominant position at play here. So the effects analysis loops back into whether there is a dominant position in the first place.

The third that struck me is that The Supreme Court venture quite confidently into an analysis of entry and consider what are the effects of entry onto the behavior in question. Perhaps we can explore that later on during this seminar.

Fourthly, the last interesting point here, which differs from the practice that is developing (particularly in Europe), is that they stress very clearly that the burden of proving an abuse of dominance rests with the party alleging the abuse of dominance and not with the party that is alleged to have breached the relevant legislation through an abuse of dominance. And that is, again, procedurally very important point.

Daniel Sokol: Thank you, Antonio. So to recap, there are three major findings that David brought up. Number one, market definition is a guide but is not necessary to establish rigid boundaries. Number two, market share is just one metric for assessing monopoly power and should be used with care. And number three, while two-sided platform issues might not be relevant at the market definition stage, they can be considered in analysis of dominance.

Antonio then added a number of additional points to add clarity to the decision from a European perspective. Will, we would turn to you. It's been a while since a high-tech issue has come before the US Supreme Court. Since Actavis last year. What are your thoughts from the US perspective on this case?

Will Tom: Well, like the other speakers on this panel, I was really quite impressed. I did think that the opinion displayed quite a lot of sophistication both about the purpose and the techniques of the market definition. It understood that a hypothetical monopolist test was not a mechanical exercise but rather a means to assess the ability of the defendant to exercise market power. And it really, as Antonio said, delved pretty deeply into the facts specific to each proposed substitute in the course of its market definition, and went beyond market share to consider factors such as ease of entry and the impact of innovation.

I'm not sure it would be quite right to call its approach a functional analysis in the sense that if you delved into the old US Supreme Court law, it had talked about whether to define markets on the basis of what products are functionally substitutable, and rejected that approach because the mere fact of offering the same function doesn't really tell you very much about what would happen in the event that a party or parties actually tried to exercise market power. And I think this opinion really did focus on the right issue, which is the thought experiment that the hypothetical monopolist test is supposed to offer. If a hypothetical monopolist in the proposed market tried to exercise market power, what would happen? And so the court went beyond functional substitutes and looked at, for example, whether single function IM services would actually constrain the behavior of suppliers of comprehensive services. And I'm not sure it would have included those companies as participants in the market had it not been for its conclusion that such companies were rapid entrants into providing full function services.

Similarly, in looking at whether mobile instant messaging services should be included in the market, it really looked not just at the functional characteristics or whether they were functional substitutes, but it also to what barriers, such as equipment acquisition costs, would inhibit rapid substitution in the event of an exercise of market power. So from a US perspective, this is very close to how we would think about market definition and market power. Maybe for the same reason that David being on the winning side of the case says, boy, this is great, being an American lawyer and having an American approach to what market definition and market power is all about it strikes me that this is a really good decision because it's so close to the way we think about things.

Daniel Sokol: Will, that's incredibly helpful and particularly if you talk about different frameworks for thinking this through as an American. I'm actually going to try a different framework here. David and Vanessa, you were the economic experts for Tencent. How did that work in a Chinese context? You've had significant experience as experts in Europe, in the United States, in Latin America. What's it like working as economic experts in the Chinese context?

David Evans: Well, let me start, Danny, by taking that and then turn it over to Vanessa, who obviously was closer to the Chinese teams we were working just because the language of the case was obviously Chinese. Let me answer that just to give a flavor of this for both the US and European audience. While the Supreme Court and the Intermediate Court were willing to take oral testimony, my involvement in this was on the paper. So the submission of expert evidence in this by both parties and the interplay was really by the submission of reports. And if you looked at the English version of those reports, they would look very much like a US expert report or a white paper that you would submit to the European Commission laying out arguments and evidence. In that sense what we did was very similar to what we do in the US and Europe with the exception that unlike the US there wasn't necessarily the kind of cross examination that you have here.

For an American, for an English speaker, it was obviously an interesting experience because eventually everything needed to be done in Chinese. Just in terms of how we ended up doing the case, we initially worked in English, but then as things got far enough along and I was kind of comfortable with the arguments from my perspective, we switched to Chinese and I relied on Vanessa to tell me where changes were being made and so forth.

So that's the perspective from my standpoint. I think Vanessa can give you probably a closer perspective from the standpoint of Chinese national acting as an expert in China before the courts there.

00:24:08

Vanessa Zhang: Yes. Working on the antitrust litigation case in China has been very challenging. And it demands seamless integration of the international experts and a global team with the local counsels. Often time we have to work closely with the litigation team on the ground and with full understanding of the specificities of internet industry in China, market characteristics and modern industrial organization theory as well as the litigation strategy. So it doesn't just demand the interpretation of culture and language differences, but also demands full experience of products and services involved and the related theory that has been applied in the case.

So if we take a bigger picture of the court system in China, academic credentials have been highly regarded. And academic publications are one of the most important criteria for economic experts in antitrust cases in China. Chinese judges, especially the judges from the Supreme Court and the provincial courts such as high courts in Beijing, Shanghai and Guangdong, have various training programs throughout the year. And they have the opportunity to interact with international scholars and the practitioners on the development of modern economic theory and anti-trust practice. Therefore they dare to take further steps into the analysis and carry out rigorous reasoning before making a decision. Yeah, that's basically our understanding on how the case has been worked out in China.

00:25:58

David Evans: The other thing I would just add to that, Danny, and the thing that may surprise some people, is the Chinese Supreme Court, unlike – well, some would argue our Supreme Court and certainly unlike the European Court of Justice, the Supreme Court is interested in basically rehearing or hearing additional factual evidence. So at the Supreme Court level it was possible to submit not only new reports but also new arguments. And that's a feature of the Chinese system that's certainly unlike my experience in the US and Europe.

Daniel Sokol: Thank you both. Just as an aside, Vanessa, I've participated in one of those training programs for Chinese judges. I thought that the judges were incredibly sophisticated, asked great questions and really cared about getting things right. I wish in other jurisdictions, including my own home jurisdiction, judges were nearly that eager to learn.

I do want to move on to a substantive question, Vanessa, maybe that you could answer. The security software was free. This is sometimes a very difficult concept for judges to understand. The fact that the software was free, did that pose any complication for the court and how did the Court handle it?

00:27:27

Vanessa Zhang: Yeah, you are right, Danny. It indeed posed complication for the court. First of all, the court acknowledged the "free" nature of the two companies' business models. They found that Internet service providers use free basic services to attract mass users, then leverage those users in value-added services and advertising to make profits. In turn, Internet companies promote their free services by those profits. That's a prevailing business model of the Internet industry. That's also why Internet service providers compete on quality, services and innovation, etc.

Therefore, when defining the relevant market, the court realized there is a limit of using the traditional Hypothetical Monopoly Test (HMT) into the Internet-based instant messaging (IM) service. So the court didn't fully take into account the price increase, but suggested a modified version by accepting a significant change over quality. In other words, it didn't use SSNIP test (small but significant and non-transitory increase in price) but accepted the test with small but significant and non-transitory decrease in quality. It is also called SSNDQ test by the court. Being aware that quality decrease could not be easily assessed and the quality data is not available, the court suggested qualitative but not quantitative hypothetical monopoly test with decrease of quality.

In the analysis the Court actually relied on product characteristics, function, quality, how difficult to acquire such a product, and other relevant factors to assess the demands substitution. And they also realized that, when it is necessary, supply substitution should also be applied. Therefore, the Court analyzed substitution between instant messaging and Weibo, SNS, mobile text messaging and email. At the end, the Court made a conclusion that relevant market is IM service market in China.

Daniel Sokol: Thank you. I guess now that we've heard about how things worked in China, Will, any reactions that you might have based on your experiences?

Will Tom: Well, I guess the first reaction is looking at the difference between generalist courts and specialist courts. It is interesting to see how much in tune this court and this decision was with standard international antitrust thinking which in some sense shouldn't be surprising because unlike our judges, by and large, these judges go to training programs at which Professor Sokol will teach them how to think about these issues. And he's obviously a very good teacher.

So that's –

Daniel Sokol: Let me add, by the way, that Will, and for that matter David, have both been gets lecturers in my class. So I outsource the teaching to the more effective teachers.

David Evans: Thanks, Danny.

Will Tom: Yeah. And unlike in the Internet market, the advertising is free and the service is expensive. So you've had your free advertising, Danny. So that's reaction number one. And, you know we all know that there are advantages and disadvantages to specialist courts. But here I think it was a clear advantage. Secondly, I think the point about dealing with the fact that the services were free; it was interesting to see how seamlessly the court handled that. Again, by focusing on what is the purpose of this exercise. The SSNIP test isn't some set of commandments handed down on stone tablets, but rather it is a tool to understand whether this defendant could really do something bad in the marketplace. Is there really a capability to illegitimately exercise power? And so it didn't get hung up on, you know what are the mechanics of modeling a 5 percent increase in price when 5 percent of 0 is still 0? But rather it did the kind of thought experiment that a hypothetical monopolist test was invented to do. Namely if this defendant, which was accused of handing consumers an all-or-nothing choice or if you will, exclusive dealing or tying, however you want to characterize it, is it really capable of implementing a harm to the marketplace by so going? And if you think about the required bundling or tie-out if you want to call it that, as a kind of decrease in quality, the court asked itself whether the facts made it plausible for market power to be exercised that way. And when it went through the possible constraints on that behavior, it pretty readily concluded that market power could not be exercised despite high market share. So, again, I thought it handled the issues pretty well.

00:34:30

Daniel Sokol: Thank you Will. Antonio, does this look similar or different based on your European perspective?

Antonio Bavasso: A bit of both: in the sense that on the one hand the Court had to grapple with the question on market definition and the analysis of impact of decreases in quality. Interested in David and Vanessa's view, but I thought that analytically the Court got a little stuck in not following what the intermediate court had done, i.e. drawing an analogy between the decrease in quality and the potential increase in price (given that conceptually the way to estimate the decrease in quality could be done by assuming increase in price).

On the other hand – and so in common with many courts - they had to come to terms with market definition. Where the approach is very different is that The Supreme Court then goes to the effects analysis and uses its findings on the effects to conclude that the behavior in question does not constitute an abuse of dominant position. And in fact is on that basis, to conclude that they alleged infringer does not hold a dominant position in the first place.

That is a very different from analysis that would typically be carried out by – a European Court. A European Court would not typically call into question the finding of a dominant position based on the effects of the behavior of the allegedly dominant firm. In Europe there is much more of a two-stage approach. We define the market to determine where is the dominant position; we then look at the alleged abuses. We never go back to call into question the dominant position, which is probably one of the reasons why some judgments – not all of them do not make an awful lot of economic sense.

Daniel Sokol: Thank you for your honesty about your perceptions of some of the decisions. I actually want to take a step back, because I think it would be helpful for those in the audience to understand. Vanessa, what was Tencent's share in what the court defined as the relevant market?

Vanessa Zhang: Yes. It depends on the calibration of the market share. And the Court has noticed in the decision that it would be effective usage time, effective usage frequency and active users. The data that has been used in the case is from iResearch. But iResearch only provides the PC-based data, which does not include the mobile-based data. So if we take monthly effective usage time as an example, Tencent's share exceeds 80 percent among the PC-based instant messaging service providers. That's also shown in the decision.

Daniel Sokol: I'm glad you raised that. Because then it leads to a much more important question. If the answer is around 80 percent, maybe, David, I could throw this in your direction. The court agreed that Tencent was not dominant. So why is it that the court dismisses this market share evidence that looks quite significant on its face at least?

00:38:58

David Evans: Yeah. No, it's very interesting. So they – part of it is what Antonio described, which is sort of the backward looking from the effects. But there's also what I would characterize as kind of a forward-looking analysis as to whether Tencent was capable of doing bad stuff. And there it really came down to their view of dynamic competition in this sector in China. So they recognized what we would call leapfrog competition--not their term—but essentially leapfrog competition where firms are constantly introducing new features to create products that are better than the other guy's products. And where are firms that are basically forced to do that if they want to keep their position. And that Tencent in fact is forced to do that if it wants to keep anything like the share that it has. My recollection is they gave the example of Microsoft's instant messaging service, which, of course, is very successful out of China, collapsing in China because of the perception that its quality was not only not that good but also that it had declined.

The court also, as Antonio and Will pointed out, placed a lot of weight on the fact of entry and the possibility that entry could discipline the large players. Then finally, they recognized this the broad competition between the platforms, the internet platforms in China, and that what these companies are really trying to do is to acquire people's attention in order to monetize it in some other way. That was kind of a driving force between the competition that was taking place. So it was that kind of analysis of the realities of market competition, at least in my reading, that led them to not place a lot of weight on the static share statistic.

00:41:30

Daniel Sokol: So this leads to a broader question. How much of the analysis is really dependent on the fact that this was an internet industry? And maybe with this question I'll return to Antonio and Will. Antonio, do you want to maybe walk us through whether or not this is highly dependent on the particular industry?

Antonio Bavasso: Well, I don't know if it's dependent on the internet industry. I think it is generally dependent on what the court perceives to be the characteristics of this industry. And the importance that innovation plays in this sector and in these markets generally. But I wouldn't infer from that that the impact of this precedent is limited. I think that a similar analysis is equally applicable as a matter of principle in all sectors where innovation can lead to what David called leapfrog entry and development. It seems to me that the court thinks that that type of analysis is central to any finding of dominance and rightly so. So that approach is rooted in the characteristics of the particular market, but is equally applicable to those markets which display similar characteristics.

Daniel Sokol: Will? Any additional thoughts?

Will Tom: I very much agree with Antonio that this is not unique to internet industries but rather is a function of the specific market being analyzed and that the broad principles would apply to any markets. You can imagine lots of internet markets in which there really is the kind of degree of lock-in and barriers to entry that would make it possible to exercise market power. Just as you can imagine lots of brick and mortar industries in which rapid entry is possible. And we've had lots of cases in highly traditional markets in which high market shares were not deemed to confer market power because entry was easy.

So I think it is very fact-specific at the level of the individual market. But principles are broadly applicable. I guess the other thing I would add here is I do think that the court was reasonably disciplined in treating the issues of market definition, market power, and anticompetitive effect or abuse separately. And so I may disagree slightly with Antonio on this point. The emphasis on lack of market power despite the high market share was really based more on the ease of entry I think than on the lack of effect. And while there was certainly a section of the opinion that dealt with whether one could infer market power from the ability of defendant to engage in this conduct, and the court rejected that possibility, it was focused on whether one could make that inference and not the other direction of rebutting the existence of market power simply from the fact that this particular conduct didn't have an effect.

00:46:30

Daniel Sokol: Thank you, Will. You raise a number of important points that there have potentially broader implications. So I thought as the last question, in fact, I'd focus on that. What is the relevance of this decision in cases in other jurisdictions? If, in fact, there is any relevance. I don't know. David, why don't I start with you?

David Evans: Yeah. I think there are three things. Obviously I don't know all the decisions out there, but at least from what I've seen, this appears to me to be one of the most important decisions concerning the analysis of fast moving internet markets. You know the other one that comes to mind is the European Commissions decision approving Microsoft's acquisition of Skype. So even though the precedential value isn't necessarily just about the internet industries, I think it is a particularly good analysis of those kinds of markets.

Second, it confirms the importance to the analysis of multi-sided platforms in antitrust. And it really is one of the two high court decisions now that recognized the concept and uses it in the analysis. The other one, of course, is the European Court of Justices decision, in September 2014, in Cartes Baincaires. That's two high courts now – one in Europe and one interestingly in China-- that has adopted the multi-sided platform approach explicitly in a decision.

And third, since we're all doing advertising here, my personal favorite, it recognizes the importance of the work I've done on attention markets--where firms compete in a variety of ways to capture scarce attention from consumers and then monetize that attention through advertising or other means. And that's the framework that I brought to the expert opinion in the case. They seemed to have picked up on that in the analysis.

Those are the three things that I would mention. The one other point that I guess I'll make if I have some liberty on this, Danny, just to respond to – maybe to respond to Will and to Antonio and to raise a question. It does occur to me that, you know one of the interesting aspects of what happens to courts is sort of a path dependence issue. The fact that the Chinese courts are beginning their development of cases by having two cases that focus on Internet industries is interesting. You wonder whether the dynamics of antitrust law would be different if like the Europeans had started with a dynamic industry rather than bananas. I think it is interesting that the Chinese are starting their analysis of antitrust with these dynamic industries. That may itself have some impact on how antitrust evolves over there. Anyway, just kind of a random thought.

Daniel Sokol: That's all very helpful. Vanessa, you've spent a lot of time working in China, but you were trained at Toulouse. You live in the United States primarily. You also are truly a world citizen and understand a number of different jurisdictions. What do you think the impact might have on any of these other jurisdictions?

00:50:38

Vanessa Zhang: Yeah. We have seen, and probably the other panelists have already raised this comment, this is the first antitrust case ruled by the Supreme Court of China. And it's also the most significant antitrust case which has set up the standard for analyzing the abuse of dominant cases in China.

Given the fast growing Chinese internet market, there might be more and more competition issues which might not have taken place in the other jurisdictions. So it would be a good example for a national supreme court to take into account rigorous economic analysis and to apply the modern industrial organization concepts into the decision. On one hand, China is trying to learn experience and lessons from its peers and trying to get in line with the international best practice in antitrust enforcement. On the other hand, China is also contributing to the international antitrust community with its own experience and dares to adopt the cutting-edge economic theory such as two-sided market theory into the antitrust analysis, which also improves our understanding of competition issues in innovation-driven industries. That's a couple of my thoughts.

Daniel Sokol: Will?

00:52:16

Will Tom: I guess I'm going to step away from the importance of this decision in terms of the economics of it and the antitrust analysis and step back to the question of institutions and the interplay of different voices on the international stage. I think one of the most significant impacts is that China will have to be taken seriously as a major contributor and thinker in this area. It is assuming a place among equals. So I think that's one thing to think about and the implications of that.

A second point is that, of course the courts in China, at least so far, have spoken only in the context of private disputes. So it will be interesting to watch the other governmental institutions in China and see whether you see a similar degree of care and sophistication. Because the executive branch, if you will, is also assuming a place among equals in the international enforcement community, and because you do not, at least as yet, see the kind of unification of those institutions that flow from the fact that in the US, for example, the agencies have to prove their cases in court. I think the dynamic in China may be somewhat more complex.

But I think that, regardless, you're seeing a tremendous globalization of antitrust and it really underscores the importance of dialogue among both the enforcers and the courts to achieve some degree of consensus about how to approach these issues.

Daniel Sokol: Antonio, I leave the last word with you.

Antonio Bavasso: I think the point that David made about what he calls path dependency, which lawyers would probably call the value of precedents, is one of the most interesting ones to my mind. It's true that we perhaps need to distinguish the judicial setting, the judgment which represents a fine example of decision making from the administrative enforcement.

The point that I find fascinating is that when China adopted an antitrust regime, it looked at European rules. Inevitably, as a result, it inherited a certain degree of "path dependency" is the presumption relating to market shares that found their root in cases such as United Brands and so on. So they've inherited a little bit of that baggage. But with this judgment the Supreme Court makes the most of being as a new kid on the block of judicial enforcement, the Supreme Court raises the stakes by adopting a very interesting judgment which does away and doesn't absorb into their judicial system all the fallacies and rigidities that have developed over the years; the rigidities coming from precedents that judges in Europe need to deal with. This is a new start with a very interesting and in many respect I would say innovative approach to those issues. So I think that the Judgment it's to be saluted as a great achievement judicially.

Daniel Sokol: Excellent. Again, this is Daniel Sokol, Professor of Law at the University of Florida and Senior Of Counsel at Wilson Sonsini. I want to thank all of our participants: David Evans of Global Economics Group, University of Chicago and University College London; Vanessa Yanhua Zhang of Global Economic Group and Renmin University; Antonio Bavasso of Allen & Overy and University College London; and Will Tom of Morgan Lewis. Thank you all very much for your participation.

ARTICLES

Net Neutrality: an EU/US Comparison

By Martin Cave & Ingo Vogelsang [1]

ABSTRACT

Net neutrality has been an issue which has preoccupied consumers, firms and regulators over the past decade. It concerns the financial and qualitative terms on which unaffiliated content and application providers (CAPs) may have their content delivered by the local access provider or ISP. The paper discusses the terms of this debate in the European Union and the US. Broadly the same view is taken in each jurisdiction of anticompetitive conduct by ISPs, such as discriminatory blocking of rival content, but the question whether ISPs should be entitled to make differential charges to CAPs for different tiers of delivery services, though nominally resolved in each jurisdiction, remains in dispute. The basic economics underlying this conflict are exposed, and intermediate solutions are examined.

I. INTRODUCTION

The recent net neutrality ("NN") proceeding before the U.S. Federal Communications Commission ("FCC") has been the most commented proceeding in the FCC's 80 year history. Almost 4 million comments were received on the proposed rulemaking issued by the FCC in May 2014.1 Thus, the net neutrality issue must be ranked as one of the most prominent regulatory topics of our time. It also could mark a reversal in the almost secular trend towards deregulation in the telecommunications and communications sector. Net neutrality in its strictest form means that no termination fees for the access of content and applications providers ("CAPs") to end users, no quality of service differentiation ("tiering") with and without pay, no degradation of traffic, no blocking, throttling, and exclusive contracts would be allowed.

The following first brings out the differences in the NN policy debate between the United States and Europe and then concentrates on paid prioritization or tiering as the most controversial remaining issue in both regions.

II. WHERE THINGS HAVE GOT TO IN THE U.S. AND EUROPE

A. United States

The U.S. Federal Communications Commission ("FCC") started formulating a net neutrality ("NN") policy in 2005 at a time when it was otherwise pursuing a deregulatory path towards the incumbent network operators that are the main Internet service providers ("ISPs"). Over the last ten years, both under Republican and Democratic leadership the FCC has persistently continued to pursue NN obligations on the ISPs, first (2005) in the form of an Internet Policy Statement without legal powers, then in a 2008 order against Comcast's policy of throttling P2P services, then in a 2010 Open Internet Order, and as of yet finally in the February 2015 order "Protecting and Promoting the Open Internet."[2] The earlier orders were struck down by federal courts, because the FCC lacked the necessary authority to establish common carrier obligations on ISPs that were classified as "information service" providers. Whether the newes order will withstand court challenges that are already lined up remains to be seen.

In its latest order the FCC takes a totally new approach by assuming authority mainly based on two sources. Following a suggestion by the January 2014 Federal Court of Appeals of the DC Circuit[3] the first source is the FCC's general authority under Section 706 of the 1996 Telecommunications Act, which is about providing incentives for advanced telecommunications capability. The second and more substantial authority is based on the application of Title II of the Communications Act to the Internet. This is a clear reversal of old FCC policy. For years the FCC had "backed itself into a corner"[4] by interpreting ISPs as providers of "information services" rather than of "telecommunication" (FCC 2002 for cable modems and 2005 for all fixed broadband access services).[5] Under the Telecommunications Act of 1996 the FCC has ample authority to regulate telecommunication services but little or no authority to regulate information services. By switching ISPs from information services to telecommunications the FCC would under Title II gain the necessary authority but, at the same time, may be seen as contradicting its own longstanding legal interpretation. The FCC now considers broadband Internet access service ("BIAS") as a telecommunications service with add-ons that can be information services.[6]

Under the telecommunications provisions of Title II the ISPs become common carriers. At the same time, many other regulations would apply that seem to be inadequate for ISPs. The FCC is therefore forbearing from most of the Title II regulations and, under a light touch approach, only applies a limited set of rules. Specifically, the FCC requires brightline nondiscrimination rules that were already part of the previous NN orders. However, this time the FCC goes further in the direction of a purer form of NN than in the previous NN orders. In the 2010 order there had been partial exemptions for reasonable network management, for mobile services and for special services that could be given priority. In contrast, under the 2015 order no tiering will be allowed at all, not even for special services that could be given priority under certain circumstances under the 2010 rule. In addition, ISPs for mobile services are covered similarly to fixed line services. They can only receive some more flexible treatment under the reasonable network management exception,[7] which remains in place but has become more specific than before.

THE FCC'S BRIGHTLINE NN RULES NOW INCLUDE:

- **No blocking.[8]**
- **No throttling.[9]**
- **No paid prioritization.[10]**
- **No unreasonable interference:[11]**
- **This is a catchall for any newly emerging or not yet discovered discriminations.**
- **Extensive transparency**

The blunt prohibition of paid prioritization (tiering) came only late in the game along with the FCC's switch to the Title II classification of ISPs. FCC's proposed NN rulemaking of Spring 2014 indicated that the Commission was leaning toward relying exclusively on Section 706 and that it would have allowed paid prioritization if "commercially reasonable." The subsequent strict denial of paid prioritization comes as a particular surprise to economists, who find quality differentiation for different consumer tastes or for different Internet applications a natural business response that comes closer to customer needs than an "onesizefitsitall" approach.[14] It may, however, come closer to the views expressed by the Internet community. Maillé and Tuffin call the NN approach the "idealistic and humanist" view, which they contrast with the "economic" view against such NN policy.[15] The former view also comes out in the FCC's emphasis on the open Internet as a "platform for speech and civic engagement."[16]

In justifying its prohibition of paid prioritization, the FCC maintains that "the threat of harm is overwhelming" and therefore exceeds any beneficial effects.[17] It also notes that there are no "practical means to measure the extent to which edge innovation and investment will be chilled" by paid prioritization.[18] Contrary to the other NN requirements, there is no exemption from the paid prioritization prohibition for reasonable network management.[19] The only remaining ways open for paid prioritization are (1) a waiver request (which must demonstrate "some significant benefit but no harm"[20] or (2) the structuring of a service that it is outside "broadband Internet access service."[21] The latter currently includes, for example, telephone services. The FCC acknowledges that some large edge providers (CAPs) can assure themselves priority services outside the ISP offerings but accepts that as inevitable.[22]

The FCC views the main NN issues as largely independent of the level of ISP competition, as long as consumers.[23] In that case, ISPs fulfill a gatekeeper function between edge providers and consumers. Mobile operators in particular can be an edge provider's only consumer access.[24]

B. Europe

It is often remarked that Europe lags behind the United States in the timing and the intensity of its concerns about net neutrality. A number of hypotheses have been advanced to explain this, including:

- **The notion of the Internet as an open and democratic space for innovation and the exercise of the right of free speech had much greater resonance in the United States, the land of the Internet's birth, than in Europe.**
- **The United States had different competition and regulatory arrangements than Europe in at least two significant respects. First, the ability in the United States to impugn the conduct of a dominant or monopoly firm was more limited, and second, a ruling of the U.S. Supreme Court (Trinko) disapplied competition law in certain case where a regulation was in place.[25]**
- **Most importantly, the fixed broadband retail market structure in the United States was much more concentrated than in Europe. Whereas incumbent ISPs in the European Union were almost everywhere obliged to share their networks or local loops with their retail rivals, in the United States such mandatory access progressively came to an end from 2004.[26] Thus, in 2006, telecommunications incumbents accounted for only 48 percent of retail broadband lines in the then 25–E.U. Member, the remainder being distributed among a variety of unbundlers, one or more cable companies, and others. Thereafter the incumbents' share continued to fall. In the United States, by contrast, the period of the NN debate saw, after 2003, the strengthening of the duopoly in most areas between a single telecommunication company and a cable company, with the cable company, often Comcast, in a position of increasing strength. As a result, in the United States, for connections of 25Mbps, 75 percent of Americans have only one provider.[27]**

The early aspects of the European discussion of NN exhibited a phenomenon which has continued to this day: of the three bodies involved in the process of lawmaking in the European Union, the European Commission, the European Parliament and the Council of Ministers (the Member States' governments)[28] – it has been the Parliament which has made the running over NN proposals. Since a large degree of agreement between Parliament and Council is required to pass a law, the restricting factor has been, and still is, the Council. The stance of the European Commission on NN was initially unworried: if there were a problem for any country, it was the United States, not Europe with its pervasive access-based broadband competition; or if there were a problem in Europe, it was one which measures to improve transparency would resolve.[29] In 2010, European Commissioner Kroes observed, à propos of NN, that "I will not be someone who comes up with a solution first and then looks for a problem to attach to it. I am not a police officer in search of a busy corner."[30]

Turning to the European NN legislation that has been enacted to date, the major instrument was the 2009 revision of the set of Directives that formed the European regulatory system for electronic communications services coming into effect in 2003. Though the term NN is not used, the proposition that "access competition + transparency on data management = preservation of network neutrality" is clearly enshrined. Thus, two changes were made within the Directives:

- **Obligations were placed upon ISPs to be more explicit about the network management policies they employed. And national regulatory authorities ("NRAs") were expressly given power to specify measurement parameters.**
- **NRAs could, subject to an oversight process, impose minimum quality standards on broadband suppliers if they had significant market power ("SMP") or dominance.**

While, in a 2012 report, BEREC (the newly created College of NRAs in Europe) collected evidence of large scale throttling and traffic management, noting that at least 20 percent of mobile customers were denied access to VoIP services,[31] it noted that new transparency rules had come into force in 2011, and observed that general European competition law provisions were already in place to deter and punish anticompetitive actions taken by ISPs in their dealings with non-affiliated content providers.[32]

Was this optimism enough to end the European NN debate? It had already become clear that it was not. Two Member States reacted forcefully to events in their domestic markets. With some of the highest capacity broadband networks in Europe and sophisticated users, the Netherlands was an early flashpoint. In April 2011, the Dutch legislature had amended the telecom law to enshrine a very strict NN obligation. Similar legislation was adopted in Slovenia, which only became law on 1 January 2013.[33]

In 2013, the Commission proposed a major reformulation of the regulatory regime, known as "Connected Continent" and designed to achieve a single market in telecommunications. This included a section on rights of end-users with a subsection proposing:

> **"The obligation on providers to provide unhindered connection to all content, applications or services being accessed by end-users – also referred to as Net Neutrality while regulating the use of traffic management measures by operators in respect of general internet access. At the same time, the legal framework for specialised services with enhanced quality is clarified."[34]**

While the Connected Continent passed and was even strengthened by amendments in its first Parliamentary reading in 2014, it was overtaken by the expiry later in that year of the mandates of both the Parliament and of the Commission. Meanwhile the Council remains hostile to the core NN proposal that prohibits or severely circumscribes opportunities for CAPs to pay ISPs more for priority transport.

In the end, the elements concerning on NN and one other matter are all that remains of the Connected Continent proposals. The situation is complicated by the new Commission's intention to conduct a wider review of regulation. When the new proposals were initially unveiled in May 2015, they merely expressed the hope that a uniform regime would be established in Europe by passage of the remaining Connected Continent proposals.[35]

On June 30 2015, the solution agreed between the Council and the Parliament, subject to formal ratification by each body, was announced, with the claim that the new rules are "the strongest in the world." On one hand, it is asserted that "there will be no paid prioritisation of any content or service or category of content or service"; on the other hand, the supply of specialised or innovative services "like IPTV, high definition videoconferencing or healthcare services like telesurgery" can be exempted "on condition that they do not harm the open Internet access."[36] The Netherlands government immediately objected that the new rules admitted price discrimination by the back door, and commentators suggested that they contained ambiguities that would have to be resolved by Member States' regulators and courts.[37]

How the situations in the United States and the European Union have changed over the past few months can be seen by the fact that one of us in a recent survey that was finished in August last year expressed the view that the European Union would end up with stricter NN regulations than the United States. Currently, in spite of the EC's own claim, the opposite result seems to prevail but, at least in the United States, the courts may still have the last word and reverse this assessment.

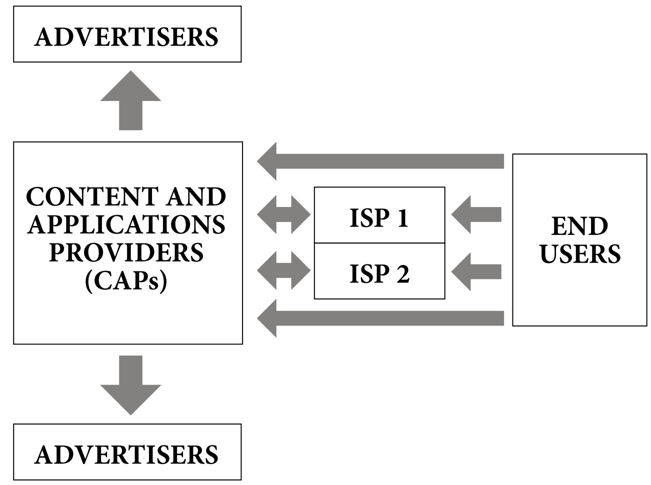
III. THE TIERING QUESTION AT THE HEART OF THE NN DEBATE

Introduction

On a number of NN issues a basic consensus seems to exist between the U.S. and E.U. policies. These include a prohibition of blocking, throttling and unreasonable discrimination, affirmative transparency requirements and an exemption for reasonable network management. However, as the previous section has demonstrated, the most controversial paid prioritization or tiering aspect of the NN debate remains. Not surprisingly, it follows the flows of money among the parties, notably the legitimacy of payments levied by ISPs on CAPs for the delivery of their content to end-users.

The totality of such flows are represented by the arrows in figure 1. End users, notably households, buy broadband services from (in this case duopolistic) ISPs. They also buy content and other services directly with content and application providers (CAPs), some of which are vertically integrated with ISPs, for example acting as providers of managed IPTV services. CAPs also receive revenues from advertisers, and end-users "pay" for such content by exposing themselves to advertisements.

Figure 1.



Note: arrows denote financial flows.

Under these arrangements, unless pre-existing strong market power is reduced, end-users are likely to end up paying in one form or another for everything; if they do not, supply will dry up. CAPs and ISPs are thus both suppliers of complements and rivals for the end users' dollar.

In the NN debate, there are three fundamentally different ways in principle in which monetary flows between CAPs and ISPs can be defined and modelled:[39]

- They can be prohibited, or confined to application in the minor exceptional cases known as specialised services; this prohibition (or confinement) lies at the core of the continuing NN debate.
- They can be subject to negotiation between the parties; this will likely generate a set of tiered rates at different quality levels corresponding to different levels of priority. The outcome of such negotiations will depend, among others, on the market power exercised by the negotiating parties. In this version, in deference to the status quo, a basic "best efforts" rate is usually assumed to be available at a zero price (but this is not necessarily the case).
- They can be set in a regulatory manner, as a regulated termination rate, in the same fashion as voice termination rates are set by regulators in the context of a "calling party pays" pricing regime, however with a potential differentiation for different Quality of Service ("QoS"). The simplest but not the only way of doing this is to set a single, uniform positive rate.

It is worth pointing out that, in relation to broadcasting platforms, there are ample precedents for negotiation between content providers and providers of platforms such as cable and satellite companies. And the resulting money flows can go in both directions, as shown in figure 1. Thus, a provider of run of the mill "commoditised" content might pay for inclusion on a platform, while the platform might pay a provider of key content to offer its services. In other words, the issue is not confined to ISP/CAP relationship alone.

It is also important that, in the case of advertiser supported content, there is no direct way in which the content provider can provide a monetary benefit to end-users to exploit its services;[40] the only thing it can do to benefit them is to reduce the advertising content. Such a transfer to end-users payment can, however, be accomplished via the ISP. Thus we find advertiser supported Facebook in some countries paying mobile operators not to count time spent on Facebook as part of the subscriber's data allowance.[41]

A. **Economic modelling**

A number of authors have applied the standard tools of economic analysis to evaluate the effects of the above noted options, and we report the results of some of them.[42] The models adopted can be either "static", which in this case normally means ignoring the effects on investment, or "dynamic" – taking effects on investment into account. As usually happens, the greater realism of the dynamic models tends to spoil the clearer and more intuitive results of the static models.

One of the earliest and most transparent models is due to Hermalin and Katz.[43] They operate with an ISP structure that is either monopolistic or duopolistic, while CAPs differ in the quality of service that they require. In effect the three options noted above are considered: a uniform QoS at either a zero or a uniformly positive price; and a menu of differentiated service levels at different prices. Indirectly mandating a uniform quality excludes certain providers, generating an effect on end-users welfare that is probably negative. This effect is most pronounced when the imposed price is zero.

This confirms a widely derived and unsurprising result that when end-users have different tastes (or different applications for the same user), their welfare can be enhanced by being able to pay different prices for different products in the market place. But work by others has shown the possibility of a counterexample. Economides and Tag introduce into a different model the impact of an externality in the content market.[44] They suppose that multiple advertiser supported CAPs dealing with a monopoly (alternatively, duopolistic) ISPs. The choice is between having a zero or nonzero termination charges. But they differ from Hermalin and Katz by supposing that end-users gain a benefit from the simple "availability" of additional CAPs, even if they do not use them. This they call a "crossgroup externality." And they show that if these externalities are high enough, then in both a monopoly and a duopoly ISP setting, NN can generate more end-user welfare than allowing positive payment for CAPs to ISPs. As before, this corresponds with economic intuition: if more CAPs confer a large enough benefit on all end-users, then this effect might outweigh the detrimental impact on variety noted by Hermalin and Katz. However, no evidence is cited for the presence of the externalities.

Within the Hermalin/Katz model for the NN result to hold, externalities would have to apply at the margin reached under a non-NN policy. Given the apparent low entry barriers for most CAPs, and their observed proliferation, one might think that the benefits offered to non-consumers by the "option" of even more of them might be quite small. However, some CAPs actually are confronted with substantial entry barriers and – like Google, Facebook or ESPN – command market power. The Hermalin/Katz model does not seem to capture, for example, exclusive arrangements between such CAPs and ISPs that could lead to Internet fragmentation, and that could happen in particular under ISP competition.

When we enter the looking glass of dynamic economic models, the mapping between assumptions and results gets more complex. As an illustration, the well known 2010 model of Choi and Kim assumes a single ISP which either levies no charge on either of the two assumed CAPs, or auctions a higher quality channel to one of them.[45] In their particular setup, they discover that it is impossible to state which regime yields the larger ISP investment, though NN encourages more investment by the CAPs. Other models are specified differently. At least some of them find NN less conducive to ISP investment than its opposite.[46]

What can we conclude from this? Simple, or even complex, economic models are not by themselves a reliable guide to economic policy. However, the static models do indicate: i) that a restriction like NN on freedom of contract has the potential to distort end-user choices, which ii) it might be expedient to do in the presence of large externalities. This predisposes us to be sceptical of outright NN tiering prohibitions and to favour the permission of negotiation for service differentiation in the absence of other cogent reasons to follow this course. But there is another potential factor – the presence of market power exercised by ISPs. This could open the door to both exploitative and exclusionary conduct – overcharging of CAPs (and ultimately of end-users) and discrimination against CAPs not affiliated with an ISP. At the same time the article cited in endnote 44 indicates that adverse effects from not enforcing NN could be more common under ISP competition than under monopoly. The example of mobile services, where competition and widespread NN violations coexisted, could confirm this.

That this has resonance with the public is shown by the fame and widespread viewing on YouTube of a diatribe in mid 2014 by John Oliver against the now abandoned Comcast Time Warner cable merger, which would have created a superISP and which encouraged a flood on opposing comments to the FCC.[47]

However, Joshua Gans[48] has shown that even with an NNstyle prohibition on charges levied by ISPs on CAPs, the same exercise of dominance by the ISP can result simply via the ISP's charges to its own customers.[49] That is, the ISP, sitting as in figure 1 at the heart of the two-sided market involving CAPs and end users, can build in content based price discrimination into its charges to end users, and thereby extract the same amount of surplus from end-users as they would from CSPs. To prevent them from doing this, restrictions on ISPs' charges to end-users ("strong net neutrality") must be imposed as well.

Moreover, Gans argues that not even competition among ISPs can prevent CAPs from being short-changed. This arises because the ultimate monopolists (in the form of singlehoming broadband bottleneck customers) are the end-users. Competition forces ISPs to maximise their upstream monopoly rents but then transfer them to end-users, via a waterbed effect. As Gans writes (informally in his blog): "that means that content providers get stuffed even when there is net neutrality regulation."[50]

B. Assessment

We have argued – probably uncontroversially – that tiering is the most durable and important extant economic issue in the NN debate. Because it hinges on the whole gamut of NN considerations, from the desirable degree of product differentiation to the best way to control market power, it is inevitably very complex, and may require compromise among objectives. In particular, if there are concerns about the use of market power by ISPs, then it is sensible to build into the regime a means of managing this risk.

The extreme approaches we have identified in our discussion range are a full NN policy encompassing no charging of among CAPs, and the application to the relevant transactions between CAPs and ISPs of nothing beyond the two regions' competition laws.

In the United States, the FCC's path is clearly set on the strict NN approach (subject, of course, to appeal to the courts). In Europe, the matter is more fluid, with major differences between the Parliament and Member States, while the European Commission pursues its own chosen objectives, one of which is to have a uniform regime to support the Digital Single Market.

In these circumstances, it may be fruitful to examine intermediate solutions. Starting for convenience from the NN end of the spectrum, one such is the making of exceptions to the "no price and product differentiation" rule. These already feature in the debate. In the United States, they are known as "special services" and parsimoniously defined as "using some form of network management to isolate the capacity used by these services from that used by broadband Internet access services." In Europe, they are known as specialised services, and their proper extent is still one of the subjects of sometimes-heated debate.[51]

The best that can be said for this approach is that if differentiation is advantageous, it is likely (but not certain) that even a small amount of it in key areas is better than none. But if the exceptions were confined to such things as emergency services, driverless cars and critical health applications, and if exceptions stop short of the bulk of commercial Internet transactions, the difference from pure NN might be small.

A broader departure from NN would be to impose certain ex ante restrictions on the transactions which ISPs could enter into with CAPs. These would bear some similarity with prohibitions under the competition laws of the two regions, but could be tailored to meet the circumstances of the case in a way that competition law cannot, and would be distinguished both by their ex ante nature and by the different enforcement mechanism which would be entailed.

The logic of this approach is to impose some restrictions on the individual negotiations between ISPs and CAPs. One main argument against allowing such paid prioritization is that monitoring and evaluating it on an individual basis is cumbersome and almost impossible. But pre-specified prioritizations based on generally available and transparent criteria are an alternative. If different applications have different QoS requirements then one should be able to design prioritization that is nondiscriminatory in the sense that it is available to all who want to pay for it. This would both reduce transactions costs for parties and reduce enforcement costs. A possible way of doing this could be to require that an operator proposing any QoS deviation from the best-effort Internet (which would first have to be defined) would have to formulate a tariffed offerings available to all customers. Such a tariff would have to contain a QoS description and a price schedule. The QoS description and potential warranties may be difficult, but that would also hold for negotiated outcomes.

The advantage of negotiated outcomes is that the ISP and the CAP have to find common QoS criteria that are verifiable. Under a tariffed version the ISP would have to come forward with a tariff notification to the regulator. In a stronger version of the rule, this would be subject to prior regulatory approval via an open process. While the price schedule would be at the discretion of the ISP, it should follow some restrictions that would prevent discrimination against small users. For example, a monthly fixed fee of a million dollars would exclude all small users, while a high usage fee would be neutral. An alternative to a usage fee could be pricing based on the capacity of lines used. The presence of notified tariffs would make it easier to enforce, for example, prohibitions on margin squeezes when the ISP was also a content provider.[52]

The next step in the interventionist progression puts considerably more detail on the setting of charges. This takes us into the territory of the regulated "termination model", where the level of charges on the CAP to be levied by the ISP are set by a regulatory process. To avoid the problem of a single quality of service, they could allow differentiation of this key attribute.[53]

In our view, this could involve crossing the Rubicon from territory, in which certain negotiating behaviours and price structures are forbidden or "proscribed", into the territory in which detailed prices and commercial arrangements are "prescribed or imposed." Yet the lack of intrusive regulation of the latter kind in data termination (as distinct from voice termination) is widely seen as one of the foundations of the success of the internet. Its practical substitute has been a flexible regime of peering and paid peering which operates in the shadow of competition law (including merger control), and has delivered results which are not perfect but satisfactory or better.[54] It has to be kept in mind, however, that this system evolved among large backbone networks that successively admitted smaller networks to the club. However, this may not work for small CAPs relative to large ISPs. Nevertheless, famously, the economist George Stigler is said always to have advised his business clients to seek to get themselves regulated: this was the reliable path to long term excessive profitability. The enthusiasm of some ISPs for the regulation of data termination *[check source]* should thus give us pause before adopting this proposal.

Where has this discussion taken us? We have three fundamental options for governing transactions between ISPs and CAPs. The strict NN proposition is to prohibit any such payment and with it, any quality differentiation. Absent a special reason such as powerful externalities, this looks likely in competitive circumstances to be welfare reducing.

In contrast, wholly unregulated ISP/CAP transactions might fare well in a world with controllable market power and few significant externalities. If the latter abound and/or are large some interference may be warranted. If the ISP sector were riddled with ineradicable market power, where tiering is concerned then even strict NN might be an n-th best outcome. (As noted above, we suspect that this may explain the more favourable view of NN taken in the United States than Europe, where broadband markets appear to be more competitive).

We have suggested that it may be fruitful to search for a solution which lies in the middle ground between the extremes of NN and wholly unregulated ISP/CAP transactions. We do not endorse the imposition of a model of regulated differentiation termination charges, but suspect that less intrusive form of intervention can both reduce transactions and enforcement costs and place a limit on, and make more transparent, any use of market power by an ISP.

IV. CONCLUSIONS

Content Service Providers (CSPs) need access to singlehoming end-users via ISPs that own the access networks. NN characterizes a termination monopoly issue, but is nonreciprocal. There are two apparently simple regulatory options for resolving the NN issue and potentially many complex regulatory options. The two simple policies are (a) no net neutrality regulation, meaning that ISPs are free to discriminate against CSPs, as long as they do not violate competition law, and (b) strict net neutrality regulation forbidding ISPs to discriminate in any way against CSPs (common carrier approach). In contrast, a complex policy would allow discrimination against CSPs based on specific criteria (case-by-case). It turns out that the simple policies are not simple after all. Specifically, under no net neutrality regulation the use of competition law may itself pose complex issues. In addition, competition law has a hard time dealing with specific externality issues raised by NN. These include internet fragmentation, the dirt road fallacy, and externality issues occurring in competitive environments. In contrast, under strict NN regulation ISPs may circumvent NN via (a) network management, or (b) peering with content providers disguised as ISPs (Netflix). Strict NN regulation may then be less constraining on ISPs than it first appears. However, it may discriminate against small CSPs (which cannot disguise as ISPs).

The two apparently simple policies have generated heated political controversies. Adopting one of them will leave large sections of the population and business community unsatisfied. This, at least from a political perspective, calls for a compromise, which would mean a more differentiated and thus more complex policy. In contrast to the simple policies, a complex policy would allow discrimination against CSPs based on specific criteria. This opens up many different policies and is likely to entail intricate design and monitoring issues. We suggested as an intermediate policy located between no and strict NN regulation to allow tiering based on publicly available tariffs that differentiate the various offerings.

The NN discussion is likely to stay alive for a while. The FCC Order is under appeal, while the European outcome has the appearance of being irresolute and inconclusive. New developments on NN evolve through the impact of firms like Google (and now Verizon) operating on both sides of the CAP/ISP street. Also, the implications of the much higher level of encryption which is now taking hold everywhere will affect the NN discussion.

1 Respectively, Visiting Professor at Imperial College Business School and Professor of Economics at Boston University. The views expressed belong to the authors alone.

2 U.S. Federal Communications Commission, *Open Internet NPRM*, 29 FCC Rcd at 5562 (2014).

3 U.S. Federal Communications Commission, *In the Matter of Protecting and Promoting the Open Internet,* Report and Order on Remand, Declaratory Ruling, and Order, GN Docket No. 14-28 (adopted February 26, 2015).

4 Verizon v. FCC, 740 F.3d 623 (D.C. Cir. 2014).

5 Kevin Werbach,"No dialtone: The end of the public switched telephone networks", *Federal Communication Law Journal* 66, no.2 (2014): 203.

6 U.S. Federal Communications Commission, *Cable Modem Declaratory Ruling*, 17 FCC Rcd at 4819, ¶ 32 (2002). U.S. Federal Communication Commission, *Wireline Broadband Classification Order*, 20 FCC rcd at 1486365, ¶1427, 1490912, ¶ 10306, (2005).

7 *See* U.S. Federal Communication Commission (2015*) supra* note 3, at 47.

8 *Id*., at 118.

9 *Id*., at 105.

10 *Id*., at 106.

11 *Id*., at 107.

12 *Id*., at 108.

13 *Id*., at 109.

14 The FCC goes so far as to interpret paid prioritization as a third degree *price* discrimination issue rather than as a *product differentiation* issue (FN 296).

15 Patrick Maillé and Bruno Tuffin, *Telecomunications Network Economics – From Theory to Applications* (Cambridge: Cambridge University Press, 2014).

16 *See* U.S. Federal Communication Commission (2015*) supra* note 3 at 77.

17 *Id*., at 19 and 291.

18 *Id*., at 19.

19 *Id*., at 20.

20 *Id*., FN 22 and 130.

21 *Id.,* at 207

22 *Id*., at 128.

23 *Id*., FN 131.

24 *Id*., at 97.

25 Eleanor Fox, "Monopolization and Abuse of Dominance: Why Europe is Different," *The Antitrust Bulletin* 59, no. 1 (2014): 129-152.

26 *See* U.S. Federal Communication Commission, *In the Matters of Petition For Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. § 160(c) (WC Docket No. 01-338), SBC Communications Inc.'s Petition for Forbearance Under 47 U.S.C. § 160(c) (WC Docket No. 03-235), Qwest Communications International Inc. Petition for Forbearance Under 47 U.S.C. § 160(c) (WC Docket No. 03-260) and BellSouth Telecommunications, Inc. Petition for Forbearance Under 47 U.S.C. § 160(c) (WC Docket No. 04-48)* (adopted October 22, 2004) and also http://www.fcc.gov/wcb/cpd/triennial_review/triennialremand.html.

27 *See* http://www.fcc.gov/document/chairmanremarksfactsandfuturebroadbandcompetition. Note that economic models suggest that the situation is more complicated than this account suggests: more particularly that departure from NN in competitive situations risks adverse events for end users which are simultaneously more frequent but less severe. *See* Ingo Vogelsang, "Will the U.S. and EU Telecommunications Policies Converge? A Survey", *Journal of Industrial and Business Economic* 42, no. 2 (2015): 117-155; *available* at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2463156.

28 Roughly speaking, the Commission drafts legislation, which is voted on by the Parliament. A compromise is then sought between the Parliament's preferences and those of the Council.

29 European Union, "Commission declaration on net neutrality," *Official Journal of the European Union*, C 308/02 (2009): 2.

30 Neelie Kroes, "Net neutrality in Europe" (speech in ARCEP Conference, Paris,13 April, 2010).

31 BEREC, "Findings on Traffic management and other practices resulting in restrictions to the open Internet in Europe," BoR (12) 30 (2012). BEREC was the newly created College of NRAs in Europe.

32 BEREC, "BEREC public consultations on Net Neutrality" BoR (12) 34 (2012).

33 *See* http://www.uradnilist.si/1/content?id=111442.

34 European Commission, "Proposal for a Regulation of the European Parliament and of the Council laying down measures concerning the European single market for electronic communications and to achieve a Connected Continent, and amending Directives 2002/20/EC, 2002/21/EC and 2002/22/EC and Regulations (EC) No 1211/2009 and (EU) No 531/2012" COM(2013) 627 final, Brussels, 11 September, (2013). The reference to "specialised services" covers exceptions to the uniform quality of service otherwise contemplated.

35 European Commission, "A Digital Single Market Strategy for Europe" COM(2015) 192, 6 May 2015, 9.

36 *See* http://europa.eu/rapid/press-release_IP-15-5265_en.htm.

37 Chris Marsden, "Oettinger: a significant step towards a digital single market without borders - European Commission," *Net neutrality in Europe*, 4 July 2015, available at http://chrismarsden.blogspot.co.uk.

38 Ingo Vogelsang, "Will the U.S. and EU Telecommunications Policies Converge? A Survey," *Journal of Industrial and Business Economics*

42, no. 2 (2015): 117-155. *Available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2463156.

39 We discuss various more practical subcases below.

40 Joshua Gans calls this a "missing price"; *see infra* note 48.

41 For a similar issue in India, *see* http://www.techrepublic.com/article/facebookgetsentangledinindiasnetneutralitydebate.

42 Our account is intended to be both summary and illustrative of a broader range of models available. It does not form an adequate basis for a full evaluation of modelling work in this area.

43 Benjamin Hermalin and Michael Katz, "The economics of productline restrictions with an application to the network neutrality debate," *Information Economics and Policy* 19, no. 2 (2007): 215–248.

44 Nicholas Economides and Joacim Tag, "Network neutrality on the Internet: A two-sided market analysis," *Information Economics and Policy* 24, no.2 (2012): 91–104.

45 Jay Pil Choi and Byung-Cheal Kim, "Net neutrality and investment incentives," *Rand Journal of Economics* 41, no.3 (2010): 446-471.

46 Marc Bourreau, Frago Kourandi and Tommaso Valletti, "Net neutrality and competing internet platforms," *Journal of Industrial Economics* 63, no. 1 (2015): 30-73.

47 *See* https://www.youtube.com/watch?v=fpbOEoRrHyU.

48 Joshua Gans, "Weak vs Strong Net Neutrality," *Journal of Regulatory Economics* 47, no. 2 (2015): 183-200.

49 Gans' argumentation is based on an exceedingly simple yet very complete model, considering net neutrality in an idealized setting without frictions arising from transaction costs or from horizontal product differentiation between content providers or ISPs. This produces strong, somewhat surprising but ultimately intuitive results across a large set of cases. If in reality there were any differences between CAP and customer discrimination then it would have to arise from realworld imperfections that the Gans model does not cover.

50 *See* http://www.digitopoly.org/2014/05/21/netneutralitymaybehardertoachievethanwethought.

51 Thus a European Commissioner described some Parliamentarians' narrow approach to such exceptions as "Talibanlike".

52 Under current EU procedures, now under review, in order to impose such a process the NRA would to satisfy itself and the European Commission that the relevant market, appropriately defined, would exhibit significant market power (SMP), unless the market in question were added to the current list of those automatically requiring analysis.

53 Interestingly, an abandoned part of the former European Commission's so called Connected Continent proposals of 2013 was precisely to set up a European wide regulated 'Assured Quality Service' of this kind.

54 Nicolas Economides, "The Economics of the Internet Backbone", *Handbook of Telecommunication Economics,* ed. Sumit Majumdar, Ingo Vogelsang and Martin Cave, (2005): 373-412.

State Created Barriers to Exit: The Example of the Acquisition of Alstom by General Electric

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ABSTRACT

This paper seeks to understand the competitive impact of State restrictions to M&A transactions that target domestic corporations. In the economic literature, a rich body of papers has examined the impact of State restrictions in terms of market access, international trade and FDI. In contrast, the consequences of State restrictions in terms of economic competition remain poorly understood. To discuss the competitive effects of State restrictions to M&A transactions that target domestic firms, the present paper offers a case study of the takeover of the French company Alstom by the U.S. conglomerate General Electric ("GE") in 2014, and of the measures adopted by the French Government to undermine it. This case is interesting. Unlike in the conventional scenario where Government intervention leads to prohibit the transaction, the Government interference did not kill the GE/Alstom transaction. Rather, in GE/Alstom, the French Government re-engineered the initial transaction. In lieu of an "absorption" of Alstom by GE as initially envisioned, the parties were forced to seal an "alliance." Our case-study shows that State interference may influence the competitive conditions in the market. In particular, we advance a counterintuitive idea. While the traditional market access literature would lead to envision State interference as a form of measure that protects the domestic firm, we show that State interference can also harm the domestic firm. In particular, in the case in point, the French Government measures may have locked Alstom behind exit barriers, by preventing it to leave the energy markets it purported to quit. We review empirical data to test our hypothesis. In practical terms, we believe our findings are interesting, because the literature on failed industrial projects suggests that Governments are often bad at making exit choices. This should be kept in mind, at a time where proponents of strong industrial policy agendas are increasingly vocal. Moreover, our analysis may have implications for antitrust policy. As much as entry barriers, barriers to exit prevent the emergence of competitive markets and are thus a concern for antitrust agencies. Additionally, State interference with M&A risk undermining the efficacy of merger control systems, in depriving antitrust agencies' ability to negotiate remedies that remove competition concerns.

I. INTRODUCTION

This paper seeks to understand the competitive impact of State restrictions to Merger & Acquisitions ("M&A") transactions that target domestic corporations. In the economic literature, a rich body of papers has examined the impact of State restrictions to M&A in terms of market access, international trade and Foreign Direct Investment ("FDI"). In contrast, the consequences of State restrictions in terms of economic competition remain poorly understood.

To discuss the competitive effects of State restrictions to M&A transactions that target domestic firms, the present paper offers a case study of the takeover of the French company Alstom by the U.S. conglomerate General Electric ("GE") in 2014, and of the measures adopted by the French Government to undermine it. This case is interesting. Unlike in the conventional scenario where Government interference thwarts the transaction – the aborted purchase of U.K. AstraZeneca by U.S. Pfizer in 2014 is a case in point – the Government interference did not kill the *GE/Alstom* transaction. Instead, in *GE/Alstom*, the French Government re-engineered the transaction. In lieu of the initially planned "absorption" of Alstom by GE, the Government forced the parties into the sealing of an "alliance."[2]

Our case-study shows that State restrictions may influence the competitive conditions in the market. In particular, we advance a counterintuitive finding. While the traditional market access literature envisions State restrictions as measures that protect home businesses, our case study shows that the State interference can harm the domestic firm. In the case in point, the measures taken by the French Government may have trapped Alstom behind exit barriers, by preventing it to leave the energy markets it sought to quit. We review empirical data to test our hypothesis. Additionally, we observe that a barrier to exit may have been imposed on GE, as well as on all prospective investors in the French economy. This barrier to exit may be, however, of lesser height than the one imposed on Alstom.

In practical terms, our findings are interesting, because the literature on failed industrial projects suggests that Governments often make bad exit choices. This should be kept in mind, at a time where industrial policy activists are increasingly vocal. Moreover, our analysis may have implications for antitrust policy. As much as entry barriers, barriers to exit prevent the emergence of competitive markets. Additionally, State interference with M&A undermines the efficacy of merger control systems, depriving antitrust agencies' ability to negotiate remedies that remove competition concerns.

The structure of the paper is as follows. Section I provides a description of the initial transaction and of the reaction of the French Government. Section II describes the transactional effects of Government interference, by undertaking a before-and-after analysis that compares GE's initial bid of April 30 with the second bid eventually accepted on June 19 by Alstom under Government insistence. Section III uses the framework of the "competitive neutrality" literature to assess the competitive impact of State intervention in *GE/Alstom*. Section IV suggests that a better approach to understand the impact of State restrictions consists in framing the issue in terms of barriers to exit within the meaning of industrial organization ("IO") and business strategy literature. Section V reviews some observed stock market data to test the hypothesis that State interference in *GE/Alstom* has created a barrier to exit detrimental to Alstom. Section VI concludes that approaching those State restrictions in terms of barriers to exit – rather than in terms of barriers to entry as conventionally done in the market access literature – refines the understanding of the large welfare costs associated with such measures, and should be of assistance to both academics and practitioners in the fields of industrial and antitrust policies.

II. INITIAL GE/ALSTOM DEAL

On April 23, 2014, Bloomberg leaks that GE is in talks to buy Alstom's for approximately $13 billion.[3] GE is a century old American firm founded by Thomas Edison, with worldwide activities in energy, finance, aerospace, pharmaceuticals, etc. It is the 4th largest U.S. firm. Alstom is a French industrial group, active in energy and transport (primarily rail). It is five times smaller than GE (in revenue). The press often describes it as a "national champion."[4]

The news electrifies the French government.[5] GE's acquisition is perceived as a threat for the 9,000 Alstom workers on French territory.[6]

On April 30, 2014, GE confirms its intention to acquire Alstom Thermal, Renewables, and Grid businesses for EUR 12.5 billion. For GE, this acquisition – the largest in GE's history – is an opportunity to gain scale in energy as utilities move to gas fuelled power plants,[7] particularly in Europe.[8] For Alstom, the sale of its energy assets will yield cash. With it, Alstom can pay down its heavy debt, and re-position on transport, the segment with the highest growth potential.

But for the French government, GE's offer remains "not acceptable."[9] A twin strategy is followed to undermine GE's plan. First, with the support of German politicians, the Government solicits a counter-offer from Siemens. Siemens, who is the main rival of Alstom and GE, is invited to play the knight in shining armor.

Second, on May 15, the Government expands the text of an existing regulation that subjects foreign investments to prior ministerial authorization. The new text now covers investments from non-E.U. firms in energy, transport and electronic communications if the interests of the State are at stake.[10] If GE is ever to acquire Alstom, it will have to demand ministerial approval, and may be imposed conditions.[11]

Weeks of negotiations follow. GE and Siemens will both revise their offers. Siemens will offer to team up with Mitsubishi Heavy Industries and Hitachi to create an "alliance" with Alstom. In this variant, the French government would take a 10 percent minority stake in Alstom.

But on June 19, GE, Alstom and the French government sign a protocol. GE will acquire the entirety of Alstom Energy for EUR 12.35 billion. In turn, GE will set up an "alliance" with Alstom, through three joint ventures ("JVs"): (i) a 50/50 JV in renewable energies; (ii) a 50/50 JV in grid; and (iii) a 80/20 JV in steam turbines for nuclear power plants and for the French market. Importantly, Alstom will use the proceeds of the sale to invest EUR 2.5 billion in the JVs.

The nuclear JV is subject to specific arrangements. The Government will benefit from a preferred share and corporate governance rights – a veto – to protect the national interest, in particular on nuclear plant security and technology.

In addition, GE commits to sell its transportation's signaling business to Alstom, and to enter into a global rail alliance with GE. Finally, GE will add 1,000 employees in France in the next 3 years (subject to penalty of EUR 50,000 per job and a cap of EUR 50 million) and keep the headquarters ("HQs") for Grid, Hydro, Offshore, Wind and Steam in France. On June 21, Alstom's board of Directors recommends GE's offer.

In parallel, the French government has been in talks for the purchase of a stake in Alstom. On June 22, Bouygues Telecom, the owner of 29 percent of Alstom shares, accepts to lend 20 percent of them (including voting rights) to the French Government. Bouygues also accepts to sell, for a period of 20 months, its shares to the French government at a pre-agreed price. With this share, the French Government will be the main shareholder in Alstom, though not with a majority.

On November 5, the restructured deal is formally approved by the Minister of the Economy.

III. RESTRUCTURED GE/ALSTOM DEAL

In this section, we seek to circumscribe the exact perimeter of the transaction following State interference, as a prior to assessing its impact on market competition. We, thus, compare the contours of the *GE/Alstom* transaction before and after State intervention. We consider side by side GE's initial offer of 30 April and GE's eventual offer of June 19.

This "before-and after" analysis is uneasy because the terms of the final offer are secret. To overcome this difficulty, we have retrieved evidence from other sources, such as corporate governance documentation, rating agencies reviews and financial analysts' reports. Those sources shed light on the final perimeter of the transaction, post Government intervention. We review, in turn, the following items: transaction price (A), transaction structure (B), transaction scope (C) and additional issues (D).

A. **Transaction Price**

Under the first GE bid, GE was to acquire the entirety of Alstom's energy activities in cash for a price of EUR 12.5 billion. Under the updated offer of June 19, the price of the proposed acquisition remained the same, for a total of EUR 12.5 billion.

B. **Transaction Structure**

1. Data

In a speech of June 20, the French Minister of the economy gave his own before-and-after analysis. He explained that GE's initial plan consisted in the "absorption" of Alstom's Energy activities. With Government interference, the offer was arguably restructured. According to the Minister of the economy, under the June 19 offer, GE and Alstom will form a "partnership of equals," a "durable ... alliance" in the energy business.[12]

Those statements deserve to be qualified.

According to our data, the scope of the said "alliance" in the June 19 protocol seems to cover only certain of Alstom's energy assets, not all of them. In particular, the concept of "alliance" obfuscates that GE will acquire the entirety – in other words, will absorb – the "core Thermal assets" of Alstom (e.g. fuel, coal and gas), as explained in GE 2Q Earnings.

In 2014, those assets represented revenues of $10.1 billion.[13] The alliance negotiated under French government influence only covers the three JVs that will be formed in "Renewable" energies (hydro + offshore); smart energy "grids" and "strategic activities" (e.g. turbines for nuclear equipment for the French market).[14]

In addition, the three JVs are structured in such a way that GE seems in sole operational control of the JVs, despite an equal distribution of ownership in two of the JVs (50/50). In its Q2 2014 Results Earning Conference Call, Steve Bolze, a Vice President at GE declared: "the deal economics remain the same [...] GE will have operational control in these joint ventures." He further added "in each JV, GE has control, will appoint the Chief Executive Officer ("CEO") and expects to consolidate. Alstom will have standard minority governance rights."[15] Industry analysts confirm this. In its June 25 Credit Opinion on Alstom, the rating agency Moody's affirmed that "The potential new Alstom would focus on its transportation activities while its energy joint ventures would be managed by GE."[16] And Standard & Poor's shares a same understanding. In a comment ofJuly 7, 2014, it declared that "GE will provide operating management and liquidity support to the JVs. Alstom's involvement will be limited to the abovementioned initial equity contribution."[17] If confirmed, this data hints that GE will hold *de facto* sole control over the energy JVs, much like in the initial April 30 offer.

On top of all this, the alliance seems temporary.[18] In his presentation to investors, Steve Bolze explained that "Alstom would have the right to sell its shares in the JVs to GE at a price that would return Alstom's investment + […]." According to him, "the timing of those out puts are slightly different, grid and renewables more in the three to four year timeframe; for the nuclear and French steam JV, more in the year 5, 6, 7 timeframe." The existence of a "put option" (read sale option) was later confirmed in Moody's Credit Opinion, where it was mentioned that "As part of the envisaged transaction with GE, Alstom will benefit from a put option with regard to its three joint ventures with GE valued at EUR 2.5 billion, which should provide Alstom with additional liquidity if and when the option is exercisable."[19] The German investment fund *ProfitlichSchmidlin Fond UI* even reported that "Some statements of the management of Alstom show that the company actually intends to exercise the put options."[20] And GE has similarly written that it "expect[ed] to consolidate" in the JVs.[21]

2. Assessment

If the above data is to be believed, then there is no significant difference between the before world – GE's absorption offer of April 30 – and the after world – GE's alliance offer of June 19. GE will immediately take over the core thermal energy activities of Alstom. In relation to the remaining energy assets (energy transition and strategic assets), three JVs will be formed. However, GE will retain full operational control in these JVs. They are therefore not real "joint ventures" in legal terms, for there is no "joint control."[22]

There is one key difference between the before and after world though. Alstom will not sell all its assets immediately to GE. It will retain a stake in all JVs (equal to an amount of EUR 2,5 billion). And this share benefits from a "put option." Analysts tend to believe that Alstom will exercise it. Overall, if one assumes analysts to be right, this makes the transaction look more like a progressive absorption of Alstom's energy by GE, than a "durable" alliance.

C. Transaction Scope

The April 30 offer was exclusively about energy. In the June 19 offer, the transaction has been enlarged to transport. GE has committed to sell to Alstom its rail signaling products and solutions, as well as to enter into a cooperation agreement in rail (to ensure cooperation in purchasing, commercialization, development, production, etc.). This transaction is valued at approximately EUR 600 million.

D. Others

A key difference between the initial and the latest offer is a GE commitment to add 1,000 employees in France,[23] with financial penalties up to EUR 50,000 per job non-added.[24] This commitment is enforceable through an independent auditor and financial penalties.[25]

In addition, GE has committed to establish HQs decision-making in France for Grid, Hydro, Offshore wind and Steam.

A last difference between the two offers relates to corporate governance rights in the third JV (nuclear activities worldwide and steam turbines in France) and the structure of capital (80/20). In this JV, the French Government will hold a preferred share (veto) as well as other corporate governance rights on specific issues that relate to security and nuclear plant technology in France.

E. Summation

This before-and-after analysis was a prerequisite to understand the true magnitude of the Government interference in GE/Alstom. It shows that the Government interference has only slightly changed the nature of the transaction (contrary to what was said in the press). All of Alstom's Energy business will be operationally controlled by GE in the short term.[26] Most of it – the core thermal assets – will be financially absorbed upon closing. The rest will be absorbed in a proximate future, if Alstom exercises the put options (which it is poised to do).

The main impact of Government intervention has been to enlarge the scope of the initial offer to transport (see table 1). Under the April 30 offer, Alstom has an option to purchase GE's rail signaling business for EUR 600 million. Beyond this, the differences between the April 30 and June 19 offers relate to employment, HQs and corporate governance rights in the third joint venture.

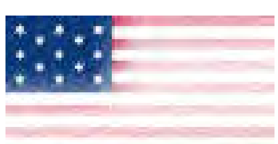
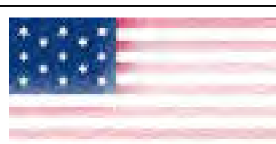
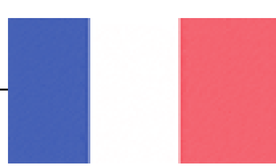
	BEFORE	AFTER
Thermal	 GE full control, EUR 8.7 Bn	GE full control of all assets, EUR 8.7 Bn 50/50 JV in steam and nuclear GE full operational control and put option
Renewable	 GE full control, EUR 1.8 Bn	50/50 JV GE full operational control and put option
Grid	 GE full control, EUR 3.7 Bn	50/50 JV GE full operational control and put option
Transport	 None	GE to sell rail signaling to Alstom EUR 600 million
Other	None	1,000 jobs and some HQs in France + Government rights in steam and Nuclear JV

Table 1: Before and after analysis of the *GE/Alstom* transaction

IV. "COMPETITIVE NEUTRALITY" ASSESSMENT OF GE/ALSTOM

Now that we understand what the French Government changed to the transaction, it is easier to assess the impact of its interference on market competition. To examine this question, we first use the framework offered by the growing body of literature on "competitive neutrality" (A). In line with this framework, we review the competitive effect of Government intervention on GE (B) and on Alstom (C) side by side.

A. Competitive Neutrality

In recent years, Western international organizations such as the OECD or UNCTAD have devoted an increased attention to the policy principle of "competitive neutrality."[27] The concern that underpins this principle is to avoid that as a result of State intervention, some government business activities "enjoy net competitive advantages over their private sector competitors."[28]

The concept of competitive neutrality was initially developed in Australia in the 1990s to address the distortive effects caused by Government business enterprises operating in commercial environments, in competition with private operators.[29] It seeks to provide a "level playing field" for all firms, whether they are government or private operators. It has gained traction when the U.S. Government pledged to promote it in international trade.[30] Since then, competitive neutrality frameworks have been rolled out across the globe and in particular in Asia and India where State Owned Enterprises ("SOEs") are prominent in the economy.[31]

In the competitive neutrality literature, the focus is often placed on the distribution of preferential advantages to State-owned enterprises, and the symmetrical distribution of disadvantages on their privately owned competitors. A 2011 OECD working paper takes, however, a wider approach, and lists "government preferential treatment to privately owned champions" as one of the two most commonly heard concerns from businesses regarding competitive neutrality.[32] The working paper gives examples such as concessionary finance, the raising of regulatory barriers to competitors, or a favorable treatment in public procurement transactions.

In this section, we rely on this extensive definition,[33] and assess the French Government's interference under the framework of competitive neutrality.[34] We examine whether in relative terms, this gave rise to the distribution of net competitive disadvantages to GE (B), and of net competitive advantages to Alstom (C).

B. General Electric

From GE's standpoint, the Government interference is not competitively neutral. Instead of disbursing a net amount of EUR 12.35 billion for the entirety of Alstom's energy business, GE's acquisition is augmented because it will have to disburse EUR 12.35 billion initially, and it may then rebuy Alstom's EUR 2.5 billion investment in the JVs under put options. Of course, GE has sole control over those assets, regardless of the put options. This notwithstanding, the revised structure of the deal is more complex that the one initially planned. Moreover, the exercise of the put option may not be seamless, for the French government is poised to take a stake of Alstom's capital.

In addition, GE's acquisition is encumbered by a variety of additional costs which include an enforceable commitment to increase the workforce by 1,000 employees; the creation of several HQs on French territory; the sale of its rail signaling operations; the inability to dispose immediately from all of Alstom's assets; and additional corporate governance concessions.

Finally, GE incurred negotiation costs to secure Government approval (hiring of lawyers, of public relation agents, etc.), and its business operations might have been slightly disrupted. In the press, it was reported that J. Immelt, GE's CEO, had to make three visits to France in less than two months.[35]

With this background, it can be said that Government interference raised the acquisition costs of GE, without making it impossible though.[36]

C. Alstom

It is unclear that Government interference has at all benefited Alstom – as might have been intended. *Firstly*, the main beneficiary of GE's concessions in terms of employment, HQs and corporate governance is the Government, not Alstom. Those advantages or benefits can thus be left out of the competitive neutrality assessment.

Secondly, the option to buy GE's rail signaling division and the cooperation agreement in rail possibly marks a competitive improvement for Alstom.[37] But this improvement cannot be examined in absolute terms. The EUR 600 million that Alstom will pay may well have received better alternative uses. For instance, Alstom may have preferred to use the EUR 600 million to pay down (some of) its heavy debt or to return (some) cash to shareholders. Furthermore, the M&A market may have offered to Alstom better opportunities in transport than the purchase of GE's rail signaling activities.[38]

Moreover, and more importantly, Alstom's commitment to invest EUR 2.5 billion in the three JVs delays the entry into effect of its intended repositioning strategy as a "pure player" in transport, the area with the highest strategic potential.[39] Until the expiry of the put options, billions of useful EUR for Alstom will remain sunk into non-strategic JVs.[40]

In brief, in so far as Alstom is concerned, State interference yields ambiguous results. On the one hand, Alstom will acquire GE's signaling business, and GE is under a duty to sell that will pressure down the acquisition price for Alstom. On the other hand, a significant amount of the cash that Alstom could have used to redeploy in transport will stay frozen in the JVs. This increases the repositioning costs for Alstom.[41]

D. **Conclusion**

The "competitive neutrality" framework is not entirely helpful. It is indeed fraught with the well-known difficulties that affect all distributional assessments. As a result, we do not find a clear-cut, typical case of Government intervention that harms the foreign firm and advantages the domestic competitor. Both GE and Alstom face increased costs as a result of Government intervention. On the one hand, the French Government intervention inflicts on GE a cost that consists in training 1,000 additional employees, as well as a number of other concessions, including HQ localization and governance-related ones. On the other hand, Alstom is not free to sell its failing energy assets as it sees fit, and it must commit to reinvest EUR 2.5 billion in energy JVs.

In addition, GE's and Alstom's costs are difficult to measure, and in turn compare. As far as GE is concerned, the financial costs imposed by Government interference are essentially linked to the commitment to recruit 1,000 employees, which can be roughly estimated to EUR 50 million (the cost of the total penalty if GE does not comply). The cost imposed by this commitment depends however, on a counterfactual conjecture, for GE may well have decided, in the counterfactual world, to increase the workforce in France. Beyond this, most costs are transaction costs (e.g. governance obligations) whose effect is complex to gauge in quantitative terms. The training costs associated to labor contracts constitute sunk costs[42] that are notoriously difficult to recoup.[43] Finally, it is difficult to measure the cost inflicted on GE by virtue of the obligation to sell its signaling business to Alstom (in particular, the reduced sale value that GE will extract, given that it is forced to sell).

The same is true of Alstom. The main effect of Government interference is to inflict an opportunity cost on Alstom, which envisioned repositioning opportunities in transport. This cost is uneasy to quantify. It could be thought of as being roughly equivalent to the interest rates to be paid on the money market, in exchange for borrowing EUR 2,5 billion.

With this background, there is no clear evidence that the Government intervention in *GE/Alstom* has altered competitive neutrality by distributing advantages to the domestic firm and disadvantages to the foreign one.

V. BARRIERS TO EXIT AND MOBILITY

In this section, we submit that the competitive effects of the Government interference can be better approached through the lenses of the traditional Industrial Organization ("IO") and business strategy literature. In particular, the somewhat under-researched concept of barriers to exit may provide a good explainer of what happened in *GE/Alstom*. Though abstract, the framework provided by IO and business strategy literature is exempt of the distributional measurement difficulties that arise when one puts the competitive neutrality canvass into practice. We first quickly review the economic literature on exit barriers (A), and then discuss *GE/Alstom* under this framework (B).

A. Literature Review

In the IO literature, barriers to exit are generally treated as an indirect form of barrier to entry. As most IO textbooks put it, if it is costly to exit an industry, there are less incentives for entry. Put differently, a barrier to exit is a barrier to entry, when entry has not taken place.[45] This finding has, however, been both formally and empirically discredited by Rosenbaum and Lamort, who show that while entry and exit are part of the same market process, they are not causally interrelated.[46]

The "contestable markets" theory makes a more thorough discussion of barriers to exit.[47] In brief, the theory contends that as long as markets are perfectly contestable, then welfare is optimized regardless of industry structure (monopoly, oligopoly or perfect competition).[48] Importantly, for markets to be perfectly contestable, and in turn optimal, exit must be "absolutely costless."[49]

The main barriers to exit identified in IO literature are sunk costs, i.e. costs that cannot be avoided if a firm exits a market (even if amortized and treated as flow). This covers, for instance, workforce training costs or advertisement campaigns. Those costs are considered sunk, for the improved skills of employees or advertising campaign are not directly salvable or reusable in case of exit.

Similarly, asset specificity is a commonly mentioned barrier to exit. A firm that has built a manufacturing plant that is highly specialized for a given production will not be able to sell those assets easily to other buyers in another industry.[50]

Strategic commitments can also play as a barrier to exit. A firm that builds a plant with a large capacity in advance of others may try to make a credible commitment to stay in the market.[51] Through this non-exit commitment, the committing firm can deter entry. Gilbert shows that sunk costs can serve as a commitment by incumbent firms not to exit the industry.[52]

Exit barriers have also been studied in the business strategy literature. Porter and Harrigan explain that "exit barriers" – the wording is distinct from IO scholars – are adverse strategic, economic and emotional factors that keep – or "trap" – firms competing in business even though they earn low or negative returns.[53] Harrigan explains that when exit barriers exist, timely extraction of a firm from a business can be delicate. She adds that barrier to exit can be deemed to be high if exit is discouraged when prices are below costs.[54]

Moreover, business strategy scholars advance the closely related concept of "mobility barriers."[55] Firms may experience problems moving from one group of firms within an industry that has peculiar structural features, to another group of firms with distinct characteristics. Take for instance a group of multi-product firms selling homogeneous goods in a vertically integrated industry. Mobility barriers would include difficulties for one firm in developing imperfect substitutes, complexities in reducing the product line width, or hurdles in vertically disintegrating.

In welfare terms, the costs of exit barriers are implicitly and unquestionably admitted in the IO literature. Most authors take for granted that the freer market exit, the more competitive the market. Instead, IO scholars have investigated other descriptive issues, such as how exit takes place in declining industries. Fudenberg and Tirole, for instance, show that in oligopolies, firms with high costs exit first. This lends credence to the efficiency of free exit.[56] In contrast, Ghemawat and Nalebuff illustrate that in declining oligopolies, large firms exit first.[57] Other papers have sought to explore proximate issues, such as the plant closing strategy of exiting firms.[58] This line of research has been complemented by empirical studies.[59]

Despite their distinct "frames of reference", "private-oriented" business strategists have actually come closer than "social-oriented" IO scholars to articulating the welfare costs of barriers to exit.[60] In a broad study devoted to exit barriers in both declining and non-declining industries, Harrigan explains that "strategic and economic exit barriers frequently deter firms from making the types of timely and frictionless exits that are assumed to be possible in economic theories of competition".[61] In turn, this has a number of detrimental effects. She observes that "relatively inefficient single-business firms may bloody an entire industry before conceding to retire if their exit barriers are high."[62] And she importantly notes that due to exit barriers, technological progress is impeded, as old-fashioned technologies do not give way to newer ones.[63]

Interestingly, some authors have examined the effects of exit barriers on technological investment. Tin *et al.* recall that investment in technology is a driver of long-term growth, and then insist on the necessity to maintain good exit opportunities for the funding of investments in technology.[64] Entrepreneurs and venture capitalists must indeed entertain a credible prospect to sell their firms to managers once technology is adopted. While those papers insist on the features of equity and stock markets in that respect, those findings can be extrapolated to the M&A market in general.

B. **Application to GE/Alstom**

The concessions given by GE and the costs imposed on Alstom fit well within the above concepts. As explained previously, GE committed to create 1,000 jobs and to locate several HQs in France. Those commitments fall neatly within the IO concept of barriers to exit. Labor costs are a well-documented form of sunk costs. Moreover, those costs are often deemed to constitute barriers to exit, because lay-offs often face resistance in the form of political intervention or legal disputes (all the more so in labor intensive industries, like steel).[65] Finally, the various HQ commitments can be analogized with a Government-imposed "strategic commitment" to keep plants and operations on French territory.

In so far as Alstom is concerned, the costs imposed by Government intervention are probably even higher. Here, the business strategy literature seems more relevant. In particular, the concept of "mobility barrier" suits the effects of Government intervention on Alstom. The sunk EUR 2.5 billion stake in non-strategic JVs retards Alstom's repositioning strategy in transport. Moreover, without going as far as arguing that this "traps" Alstom in a loss-making market, the EUR 2.5 billion stake may undermine its ability to pay down debt, to return cash to shareholders, and possibly to undertake a more profitable, alternative strategy.

Lastly, the regulation that subjects foreign investments to prior ministerial authorization ("the regulation") elevates a transversal exit barrier in all sectors where a firm "activities [...] are essential to preserve France's interests in terms of public policy, public security or national defense."[66] In short, the regulation makes domestic firms' exit deals conditional on Government approval. With this, moreover, comes a bargaining process with Government institutions, which is likely to feature a certain degree of media exposure and negative publicity. Managers from domestic firms may well delay purported exit strategies for fear of such measures.[67]

Of course, the regulation specifies an exhaustive list of those national interests.[68] But the early practice in GE/Alstom suggests that the French Government makes an extensive, and rather unpredictable interpretation of the scope of the regulation. The French Government deemed Alstom, a 99 percent privately owned firm, a "national champion" or a "strategic firm" worthy of protection by virtue of the fact that Alstom was once under State control (until 2006); that Alstom's main clients (and revenues) are large SOEs, in utilities notably; and that Alstom entertains industrial partnerships with SOEs (for instance, Areva).[69] Under this approach, virtually any firm that once had the State as a client or supplier, that once was granted a subsidy, or that once had the State as shareholder, can be deemed a "national champion" whose exit ought to be prevented. Clearly, this is likely to create a source of uncertainty for investors. And in welfarian terms, this unpredictability should be thought of through the lenses of the literature that documents a negative impact on uncertainty over investments.[70]

To conclude, it ought to be noted that if barriers to exit are to be understood as indirect barriers to entry, this may have indirect positive effects for *GE/Alstom*.[71] After all, both companies are in the market. If the existence of the regulation increases entry costs for other possible entrants, then the merged *GE/Alstom* is shielded from competition. This, however, remains a concern from a consumer welfare standpoint, for consumers will face a market that is not subject to the competitive threat of entry.

VI. MARKET DATA

Our argument that Government interference raised a barrier on the exit or mobility of Alstom is primarily qualitative. So far, we have assumed that Government interference imposed a burden on Alstom through the changed transaction structure, because the new structure was different from the original one. In turn, this relied on the implicit assumption that the initial transaction was from Alstom's perspective the optimal one.

We have sought to verify this on the basis of market data. To that end, we have retrieved data on Alstom's equity valuation (share price) in Bloomberg between January 6, 2014 and January 6, 2015. We try to observe the evolution of Alstom's equity between April 23, 2014 when the initial transaction was leaked to the market and June 19 when the Government restructured deal was publicized. The red arrow shows that the initial GE offer was well received by the market, with a +36 percent spike in the price of Alstom's share. This tends to confirm our proxy that Alstom's initial plan was the optimal one. The green circle, in turn, corresponds to the Government's June intervention. It shows a concomitant decrease of Alstom equity by almost a half. With this, one may conjecture that State interference dissipated by almost a half the positive April effect. Lastly, we denote with an orange circle the formal authorization of the deal by the Government in November. Again, this coincides with yet another decrease of Alstom's equity valuation.

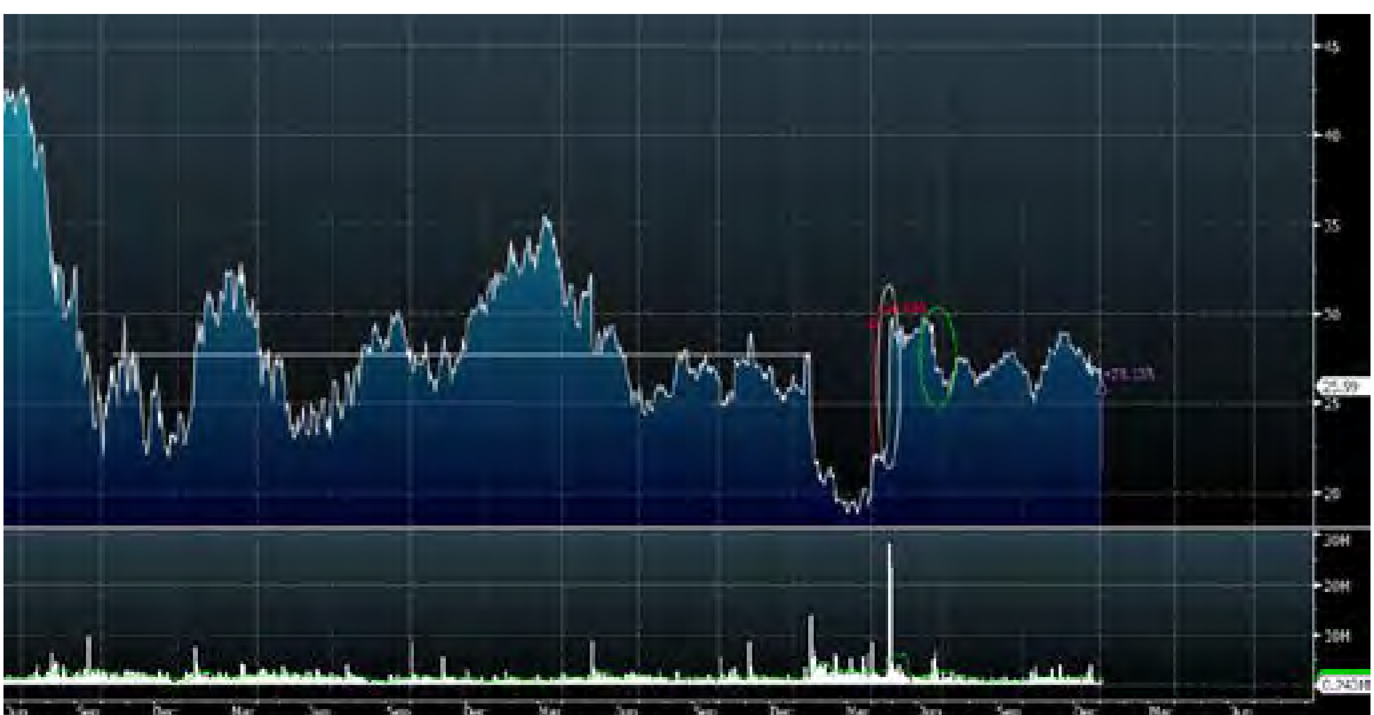
This data tends to suggest that Government interference may have harmed Alstom, as conjectured in the previous section. That said, this observation must be interpreted with utmost caution. Markets, and in particular, equity markets are fallible.[72] Moreover, we are well aware that our proof is at best conjectural, and that many other factors that cannot be controlled for may causally explain the evolution of Alstom's equity.

VII. THEORETICAL AND PRACTICAL RELEVANCE

Our reading of the State interference in *GE/Alstom* as a measure that elevates exit barriers has four theoretical merits, which are discussed in turn.

A. Contribution to the Literature on Regulatory Barriers

The main finding of this paper is that the Government interference in GE/Alstom gave rise to exit and mobility barriers. In and of itself, this finding will enrich the scant literature on State-induced exit and mobility barriers. Only a few studies have to date been devoted to such barriers. Harrigan, one of the most prolific author on exit barriers, only mentions



them in passing, noting succinctly that "Governmental policies intended to maintain employment levels such as "state ownership" of facilities [...] can be exit barriers."[73] In our review of the literature, we also found a study by Lee, Peng and Barney which examines bankruptcy laws that delay exit can affect the potential for entry.[74]

Beyond this, however, the literature does not seem to pay much attention to legal or regulatory exit barriers. The IO and business strategy papers are indeed primarily centered on the firm and their managers, and often neglect to apprehend the importance of the regulatory environment. This is unfortunate, for many such barriers seem to exist in the day-today economy: restrictions to secondary trading; prohibitions on the resale of licenses, authorizations, and special rights; labor laws and protective trade union statutes; etc.

B. Beyond Entry Analysis

As surmised previously, in the international trade theory literature, many State restrictions on market access are envisioned in terms of "market entry."[75] In other fields, like welfare economics or entrepreneurship, the focus is also primarily placed on entry.[76] In contrast, in the economics literature, the impact of such restrictions on "exit" remains little researched.[77]

This focus on entry is unfortunate. First, in the *GE/Alstom* case, GE's market entry could not possibly be hampered, for GE has already been present for decades in Europe and in France with its own production capacities. In other words, State restrictions to the acquisition of domestic capital do not necessarily raise barriers to entry.

Moreover, this, one only envisions the societal costs of FDI restrictions myopically by looking at one side of the story, e.g. the situation of the foreign entrant whose market access is hampered. However, this misses the forest for the trees, e.g. the costs possibly inflicted upon the domestic firm, whose entry belongs to history, and who may be "trapped" in the market by virtue of State action. Moreover, the obsessive focus on entry deterrence also omits to consider the situation of foreign entrants who overcome the entry barrier in exchange for unrecoverable sunk concessions that limit their ability to exit in the future.

In our view, the notion of exit barriers gives a fuller, more complete account of the competitive costs of Government intervention. It is our submission that when assessing the impact of State measures of the kind found in *GE/Alstom*, policy makers should systematically review them through the lenses of the theory of exit and mobility barriers, in addition to thinking of them as entry impediments.

C. Exit Choices and Industrial Policy

In recent economic literature, a growing body of influential authors has called for a "rejuvenation" of industrial policy measures. Stiglitz, Lin and Monga argue that Governments can play an instrumental role in sponsoring market players where externalities and public goods issues occur, such as in the market for the production of knowledge.[78]

Rodrik, however, recalls the usual caveat against industrial policy: such measures "are often derided because they may lead to picking the losers rather than the winners."[79] Nevertheless, he believes that this is a necessary evil that should not distract Governments from engaging into such programs.[80] Rather, Governments should focus on trying "to minimize the costs of the mistakes when they do occur."[81]

However, while this would literally entail phasing out mistaken industrial programs, this is unlikely to happen. As Seabright explains, once they have sponsored a project, Governments are notoriously bad at making exit choices and do not like to shut down costly industrial ventures. In his words, "politicians, responding to well-understood electoral and lobbying pressures, are reluctant to close projects."[82] The empirical literature on public project disasters brings myriads of examples of this.[83] In a seminal book, Myddelton reviewed six large British government quasi-commercial twentieth-century projects that all "went wrong."[84] Key examples were the Concorde aircraft, the Channel Tunnel and the Millenium dome. On the Concorde, from the 1960s, the U.K. government reviewed the project every six months. There were regular increases in the cost estimates. This notwithstanding, the Concorde was left in operation up until 2003. Eventually, "Concorde's costs, kept secret for years, totaled £9,600 million, an overrun of 300 percent in real terms. The aircraft took thirteen years to design and build, twice as long as planned."[85]

It is against this backdrop that the concept of State-induced barriers to exit proves useful. Much like with perfused, loss-bleeding industries who keep on receiving State subsidies, the elevation of exit barriers around a strategic firm may just symptomatize a degree of Government reluctance to pull the plug on a failed project. And since it is a less costly – and possibly less unlawful – measure than net State subsidy, such initiatives may be more attractive to Governments, in particular in dire fiscal times.

As Seabright indicates "allowing projects to fail and disappear is a very important part of innovation and productivity growth in a modern industrial economy."[86] The elevation of Government exit and mobility barriers is in direct opposition with this idea, and should thus be discouraged. There are, indeed, numerous examples of large, strategic organizations that successfully responded to deep economic crisis with repositioning strategies. In the early 1990s, for instance, IBM was in a dire financial situation. It undertook a dramatic change in strategy, by leaving the very competitive desktop markets, to refocus on business applications.[87] Similarly, Ericsson made a successful move from mobile handsets towards the provision of "turnkey" wholesale network solutions for telecoms operators. Those success stories should inform Government choices, when they contemplate forcing a strategic firm to stay in an industry that it wants to quit.

D. Bargaining with Government and Antitrust Policy

Antitrust agencies across the world are in charge of policing market competition. This mission generally includes the *ex ante* scrutiny of M&A transactions. In 2015, more than 200 countries had merger control regimes. As a result, hundreds of M&A transactions are reviewed each year by antitrust agencies. Some are prohibited. Most are cleared. Often, the remedy in problematic merger cases consists in negotiating divestitures with the parties or concessions of other sorts (including pricing, licensing and other commitments). Keeping the ability of antitrust agencies to extract remedies that allay competition concerns is of critical importance for the maintenance of competitive markets.

So far the effects of Government interference on merger policy have been little researched.[88] In theory, if State interference leads to the early abortion of a merger that would be subsequently deemed anticompetitive by the antitrust agency, then there is no problem. In fact, this will save administrative costs for antitrust agencies. Conversely, if State interference reins in a pro-competitive merger that would be subsequently cleared by the antitrust agency, then there is no effect either because the merger control system does not seek to promote, encourage or fabricate pro-competitive mergers, just to prevent the consummation of anticompetitive ones.

However, what has been perhaps less clearly understood is the effect of State interference of the kind observed in *GE/Alstom*, where the transaction is conditioned on certain commitments. This type of interference may impact on the effectiveness of merger control systems for a simple reason: the early bargaining process that takes place between the parties and Government may pre-empt the amount of concessions that the parties are ready to make, leaving little for antitrust agencies to obtain from the parties if competition concerns appear. To take a graphic example, GE's board may be reluctant to offer divestments to solve antitrust regulators' concern, having been previously coerced to divest their signaling business under State interference. In other words, prior State interference may exhaust the amount of concessions that antitrust agencies can obtain. It risks turning the parties in non-cooperative spirit at the later stage of merger scrutiny by the antitrust agencies. This, in turn, exacerbates the risks of antitrust prohibition, while competition concerns could have been solved with remedies (type I error). An alternative is that having decreased the maximum amount of potential concessions that the parties can offer, the Commission will end up accepting under-fixing remedies (type II error).[89]

In my opinion, this risk of remedy fatigue additionally legitimates that antitrust regulators take an interest in prior Government intervention, and possibly unwind the conditions imposed previously. In addition to raising exit (and mobility) barriers, that constitute a typical antitrust concern, such restrictions call into question the very effectiveness of antitrust institutions. In the E.U., a legal instrument exists to this effect. Article 21 of the merger control regulation imposes on Governments to notify the conditions imposed on mergers to the E.U. antitrust agency.[90]

VIII. CONCLUSION

This case-study has examined the impact of the French Government intervention in the acquisition of Alstom by GE. It shows that State interference has only marginally altered the initial M&A transaction negotiated by GE and Alstom. GE will absorb most if not all of Alstom's energy activities.[91]

In addition, it suggests that while State interference may be innocuous in transactional terms, it may be more harmful from a competitive perspective. In particular, the Government-attempted reshaping of the initial offer may have restricted competitive exit and/or mobility opportunities for both firms.[92] This is interesting, because the problem with State restrictions to foreign M&A may therefore not lie where the literature on competitive neutrality believes it is, e.g. advantaging the local firm at the expense of the foreign one. Instead, the Government intervention may just have been neutrally anticompetitive, by degrading competitiveness across the board.

With this background, Government interference of the kind found in *GE/Alstom* should also be approached from the IO and business strategy perspectives. In particular, the notion of barriers to exit helps understands the cost of government interference with M&A transactions that involve domestic champions. Competitive exit is a crucial feature of well-functioning markets. Academics, policy makers and practitioners from all sides – industrialists, antitrust advocates, etc. – should keep this in mind when thinking about such measures.

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2 Hugh Carnegy, "France Claim victory in Forcing GE to Revise its Alstom Energy Bid", *Financial Times*, June 22, 2014, http://www.ft.com/intl/cms/s/0/4fae5558-fa15-11e3-a328-00144feab7de.html.

3 Aaron Kirchfeld, Matthew Campbell and Jeffrey McCracken, "General Electric Said in Talks to Buy France's Alstom," *Bloomberg,* April 24, 2014, http://www.bloomberg.com/news/2014-04-23/ge-said-in-talks-to-buy-france-s-alstom-for-about-13-billion.html.

4 Gilbert Reilhac, "Alstom workers relieved as GE wins takeover bid," *Reuters*, June 24, 2014 http://www.reuters.com/article/2014/06/23/us-alstom-generalelectric-idUSKBN0EY2DC20140623.

5 In a tweet, the Minister of the economy Arnaud Montebourg talks of a "breach of national ethics." In the past years, Montebourg has been the champion of "economic patriotism," a modern offshoot of mercantilism (or of its French version, colbertism), a doctrine that purports to promote local production by all means.

6 In the energy sector. It should be noted, however, that GE is not the archetypal foreign predator. GE has headquarters and factories in France since 1999, and it employs there more than 10,000 workers.

7 Turbines are used in power plants, to convert gas and steam into electricity.

8 GE also sees potential synergies with its turbines portfolio.

9 Mark John, Ingrid Melander, Benjamin Mallet and Natalie Huet, "France's Hollande says GE must improve Alstom bid," *Reuters*, May 6, 2014 http://www.reuters.com/article/2014/05/06/us-france-alstom-idUSBREA4505R20140506.

10 *See* Décret no 2014-479 du 14 mai 2014 relatif aux investissements étrangers soumis à autorisation préalable. This regulation expands Article L151-3 of the Code monétaire et financier. Pursuant to this text the minister of economy has the power to impose conditions on foreign investments, to enjoin them and to sanction breaches of ministerial the decisions. This regulation has been labeled "Décret Alstom."

11 The legality of this document under E.U. law is dubious. However, in end June, the European Commission informally explains that the regulation is compatible in its wording, though not necessarily in its application. Tim Worstall, "France breaks European union law to blocka GE bid for Alstom, " *Forbes*, May 16, 2014, http://www.forbes.com/sites/timworstall/2014/05/16/france-breaks-european-union-law-to-block-ge-bid-for-alstom/.

12 *See* Conférence de presse d'Arnaud Montebourg sur Alstom, 20 juin 2014.

13 *See* GE 2nd Quarter 2014 Earnings (this also includes biomass, tidal energy, etc.), *available at* http://www.ge.com/investor-relations/ir-events/ge-2nd-quarter-2014-earnings-webcast.

14 *See* http://www.genewsroom.com/Press-Releases/GE-Announces-Energy-and-Transport-Alliance-with-Alstom-97412. It is agreed

that Alstom will use the proceeds of the sale to buy back 50 percent of each of the JVs, by EUR 2,5 billion.

15 *See* Seeking Alpha Transcript, Q2 2014 Results Earning Conference Call, July 18, 2014. Similarly, a PowerPoint presentation of 18 July 2014 where GE comments its Q2 performance affirms twice that the three JVs will be under "GE operational control." *See* GE 2014 second quarter performance, Financial Results and Company Highlights, July 18, 2014, http://www.ge.com/sites/default/files/ge_webcast_presentation_07182014_0.pdf.

16 *See* Moody's Investors Service, Credit Opinion, Alstom, 30 June 2014.

17 *See* Standard and Poor's, Rating Direct, 7 July 2014, France-Based Alstom 'BBB-' Ratings Affirmed On Accepted Offer Of Power Assets Sale To General Electric; Outlook Stable.

18 Richard A. Kessler, "Alstom to have GE JV sales clause," *Rechargenews,* July 18, 2014, http://www.rechargenews.com/wind/1369954/Alstom-to-have-GE-JV-sales-clause.

19 *See* Moody's Investors Service, Credit Opinion, Alstom, 30 June 2014. This was also mentioned in other official documents from the parties.

20 "Alstom: Overengineering einer Übernahme?,"*profitlich-schmidlin*, August 1, 2014, http://profitlich-schmidlin.de/archive/749.

21 *See* GE 2014 second quarter performance, Financial Results and Company Highlights, July 18, 2014, http://www.ge.com/sites/default/files/ge_webcast_presentation_07182014_0.pdf.

22 *See* B.II.3 of the 2008 Consolidated Jurisdictional Notice, in particular at §62 which states that "joint control is characterized by the possibility of a deadlock situation resulting from the power of two or more parent companies to reject proposed strategic decisions"; and *see* §63: "There is joint control if the shareholders (the parent companies) must reach agreement on major decisions concerning the controlled undertaking (the joint venture*)*." Finally, *see* §81 which recognizes that joint control can exist even when a "parent company can play a modest or even non-existent role in the daily management of the joint venture where its presence is motivated by considerations of a financial, long-term-strategy, brand image or general policy nature." But the Commission adds "Nevertheless, it must always retain the real possibility of contesting the decisions taken by the other parent company on the basis of equality in voting rights or rights of appointment to decision making bodies or of veto rights related to strategic issues. Without this, there would be sole control."

23 In the three next years. For more on this commitment,"Alstom: Montebourg annonce des pénalités pour chaque emploi non créé par GE, " *l´express*, June 23, 2014, http://lexpansion.lexpress.fr/actualite-economique/alstom-montebourg-annonce-des-penalites-pour-chaque-emploi-non-cree-par-ge_1553385.html.

24 *Id.*

25 Tomas Kelner,"Alstom Accepts GE´s updated offer," *Ge Reports,* June 23, 2014, http://www.gereports.com/post/89252315760/alstom-accepts-ges-updated-offer.

26 This represents 71 percent of Alstom's turnover (2013-2014). Geraldine Amiel, "GE Is in Talks to Buy Alstom's Energy Business," *The Wall Street Journal*, April 24, 2014, http://online.wsj.com/news/articles/SB10001424052702304788404579521601019616462.

27 OECD. "Competitive Neutrality: Maintaining a Level Playing Field Between Public and, Private Business," *OECD*, (2012), Paris.

28 This is the seminal definition of competitive neutrality of the Australian government. *See* Commonwealth Competitive Neutrality Policy Statement, June 1996, at 3, http://archive.treasury.gov.au/documents/275/PDF/cnps.pdf.

29 Mark Pearson, "Competitive Neutrality." - *Discussion Paper 8th Seoul Competition Forum*, September, (2014): 1–10. Zahirul Hoque and Jodie Moll, "Public sector reform-Implications for accounting accountability and performance of state-owned entities –an Australian perspectives," *The International Journal Of Public Sector Management,* no 14 (4) (2001): 304-326.

30 Kar P. Sauvant, Persephone Economou, Ksenia Gal, Shawn Lim, and Witold P. Wilinski, "Trends in FDI, home country measures and competitive neutrality", in *Yearbook on International Investment Law and Policy 2012-2013,* ed. Andrea K. Bjorklund (New York: Oxford University Press, 2014), ch.1.

31 OECD *supra* note 27.

32 Antonio Capobianco and Hans Christiansen, "Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options," *OECD Corporate Governance Working Papers*, no. 1 (2011): 30.

33 They do not primarily seek to keep market structures competitive. They rather try to keep the capital, labor or production centers on national territory.

34 After all, State measures that protect domestic champions from foreign acquisition may too harm competitive neutrality by shielding them from the discipline generated by the M&A markets. In the abstract, those measures include outright State appropriation of the coveted assets, efforts to sponsor competing acquisitions, forced enrollment in joint-ventures with local champions, and more generally all *ad hoc* measures that raise the cost of acquisition for the purchaser. The undergirding motives for such measures are well documented in the political economy literature.

35 Ed Crooks, "Vindication for Immelt in GE's Alstom bid." *Financial Times*, June 23, 2014, http://www.ft.com/intl/cms/s/0/00d38fd4-fa29-11e3-9f7e-00144feab7de.html.

36 In industrial economics and management literature, a firm that acquires a rival is said to follow a strategy of "expansion" through "external growth." *See* Edith T. Penrose, *The Theory of the Growth of the Firm*, (New York, Oxford University Press, 1995).

37 Following this acquisition, Alstom's position in rail signaling will remain behind Siemens, the market leader (market share of 21 percent) and at a similar level as that of Thales (13 percent). *See* Natixis Equity Research, 5 Aout 2014.

38 Even though GE's signaling business is more profitable than Alstom's transport operations.

39 *See* Moody's Investors Service, Credit Opinion, Alstom, 30 June 2014.

40 Though the shares in the JVs will pay off dividends.

41 The hypothesis that the French Government harmed Alstom more instead of protecting may be further confirmed by circumstantial evidence, such as the fact that Alstom never turned to the French

Government for protection. Leaks in the press subsequently brought the Government in the process, on its own motion. Alstom was the one that took the initiative of entering into negotiations with GE, hoping to enter into a sale and purchase transaction with the later under standard market conditions.

42 *See* OECD "Policy Roundtable on barriers to entry," DAF/COMP (2005) at 28, www.oecd.org/daf/competition/abuse/36344429.pdf.

43 Paul Belleflamme and Martin Peitz, *Industrial organization: markets and strategies*, (UK, Cambridge University Press, 2010), 15.

44 Dennis W. Carlton and Jeffrey M. Perloff. *Modern Industrial Organization*, (Addison Wesley, 3rd Edition, 1999), 125. A variant of this theory is that barriers to exit raise barriers to entry. This is because if barriers to exit affect the competitive incentives of the established firms and make them more formidable competitors than they would be if barriers of exit were small, then that may defer potential entrants (*see* e.g., Ghemawat and Nalebuff, 1985, Fudenberg and Tirole, 1986).

45 We are grateful to Pierre Larouche, who suggested this wording to us.

46 David Rosenbaum and F. Lamort, "Entry, barriers, exit, and sunk costs: an analysis", *Applied Economics*, no. 24 (1992): 297–304.

47 William J. Baumol, John C. Panzar, and R.D. Willig, "Contestable Markets: An Uprising in the Theory of Industry Structure: Reply", *The American Economic Review* 73, no. 3 (1983): 491-496.

48 William J. Baumol, "Contestable Markets: An Uprising in the Theory of Industry Structure", *The American Economic Review* 72, no. 1 (1983): 1-15. Baumol argues that in contestable markets, "zero profits must characterize any equilibrium." And the "second attribute of any contestable market is the absence of any sort of inefficiency in production in industry equilibrium."

49 This is because what keeps prices low on markets is the threat of "hit and run" strategy. Baumol (1982, at p.4) means that a potential entrant must be free to go in, "and, before prices change, collect his gains and then depart without cost, should the climate grow hostile."

50 Li, Willis and Xu, "Asset Specificity and Management Forecasts," *Financial Accounting and Reporting Section,* 2014 – Annual Meeting Sessions, http://aaahq.org/AM2014/display.cfm?Filename=SubID_1561.pdfandMIMEType=application percent2Fpdf.

51 Dennis W. Carlton, "Why Barriers to Entry Are Barriers to Understanding," *The American Economic Review* 94, no. 2, (2004): 466-470.

52 Richard Gilbert, "Mobility barriers and the value of incumbency," in *Handbook of Industrial Organization,* ed. Richard Schmalensee and R. Willig (Elsevier Science Publishers B.V., 1989) ch. 8.

53 *See* Harrigan, *infra* note 54. *See* also Michael E. Porter, "Please Note Location of Nearest Exit: Exit Barriers and Planning," *California Management Review* 19, no. 2 (1976) and Paul Geroski, Richard J. Gilbert and Alexis Jacquemin, "Barriers to entry and strategic competition," *Fundamentals of Pure and Applied Economics,* (1990): 41, 97., who say that an exit barrier exists if incumbent firms earn profits that are less than the profits that can be earned by firms that have not entered the industry, at 59.

54 Kathryn R. Harrigan, "Deterrents to divestiture," *Academy of Management Journal* 24, no. 2 (1981): 306–323.

55 Richard E. Caves and Michael E. Porter, "From entry barriers to mobility barriers: Conjectural decisions and contrived deterrence to new competition," *The Quarterly Journal of Economics* 91*,* no. 2 (1977): 241–262.

56 Drew Fudenberg and Jean Tirole, "Dynamic Models of Oligopoly," *Fundamentals of Pure and Applied Economics* 3, (1986).

57 Pankaj Ghemawat, and Barry Nalebuff, "Exit," *The RAND Journal of Economics* 16, no. 2 (1985): 184-194.

58 Stanley Reynolds, "Plant Closings and Exit Behaviour in Declining Industries," *Economica 55,* no. 220 (1988): 493–503. Michael Whinston, "Exit with multiplant firms," *The RAND Journal of Economics* 19, no. 4 (1988): 568–588.

59 Mary Deily, "Exit Strategies and Plant-Closing Decisions: The Case of Steel," *The Rand Journal of Economics* 22, no. 2 (1991): 250–263. Shane Greenstein and James Wade, "The product life cycle in the commercial mainframe computer market, 1968-1982," *The RAND Journal of Economics* 29, no. 44 (1998): 772–789.

60 Michael Porter, "The Contributions of Industrial Organization to Strategic Management," *Academy of Management Review* 6, no. 4 (1981): 609–620.

61 Harrigan, *supra* note 54

62 However, Harrigan also notes that the effects on competition are at times ambiguous. For instance, efficient firms "may not possess the longest staying power or the commitment to fight it out if exit barriers are relatively low" (Harrigan, 1982, at pp. 730 and 731), in contrast to less efficient incumbents who may "resist liquidation because they involve shattered dreams" or because "the very idea of walking away from a [industrial] heritage would seem heretical."

63 Kathryn Harrigan, "Exit Decisions in Mature Industries," *Academy of Management Journal* 25, no. 4 (1982): 707–732.

64 Tin Katrin, "Technology Adoption with Exit in Imperfectly Informed Equity Markets," *The American Economic Review* 100, no. 3 (2010): 925-957.

65 *See*, for instance Kathryn Harrigan and Michael Porter, "End-Game Strategies for Declining Industries," *Harvard Business Review*, (1983), who talk of social barriers associated with putting people out of work.

66 *See* Article R 153-2 of the Décret Alstom, as mentioned above. It applies only to foreign investments made firms whose headquarters are outside of the territory of the Member States: "Relèvent d'une procédure d'autorisation au sens du I de l'article L. 151-3 les investissements étrangers mentionnés à l'article R. 153-1 réalisés par une personne physique qui n'est pas ressortissante d'un Etat membre de la Communauté européenne ou d'un Etat partie à l'accord sur l'Espace économique européen ayant conclu une convention d'assistance administrative avec la France, par une entreprise dont le siège social ne se situe pas dans l'un de ces mêmes Etats ou par une personne physique de nationalité française qui n'y est pas résidente, dans les activités suivantes."

67 Harrigan (1980; 1982) talks of emotional barriers to entry. Kathy Harrigan, "Strategies for declining industries," *Journal of Business Strategy* 1, no. 2 (1980): 20-34.

68 It talks of integrity, security, and continuity in the supply of (i) electricity, gas or energy; (ii) in the supply of water; (iii) in the exploitation of transport networks and services; (iv) in the exploitation of communications networks and services; (v) in defense related issues as defined in other legal provisions; and (vi) in public health.

69 "Arnaud Montebourg veut qu'Alstom prenne son temps," *le figaro.fr*, April 27, 2014, http://www.lefigaro.fr/societes/2014/04/27/20005-20140427ARTFIG00090-montebourg-veut-qu-alstom-prenne-son-temps.php.

70 Nathan Wilson, "Uncertain regulatory timing and market dynamics," *International Journal of Industrial Organization* 1, no. 30 (2012): 102–115. Alan Carruth, Andy Dickerson, and Andrew Henley, "What do We Know About Investment Under Uncertainty?" *Journal of Economic Surveys* 14, no. 2 (2000): 119–154.

71 We are grateful to Mario Mariniello for bringing this point to our attention.

72 Luca Aguzzoni, Gregor Langus and Massimo Motta, "The Effect of EU Antitrust Investigations and Fines on a Firm's Valuation," *The Journal of Industrial Economics* 61, no. 2 (2013): 290–338.

73 Kathryn Harrigan, "Overcoming Exit Barriers," in *Palgrave Encyclopedia of Strategic Management,* ed. David Teece and Mie Augier (2013).

74 Seung-Hyun Lee, Mike W. Peng, and Jay B. Barney, "Bankruptcy law and entrepreneurship development: A real options perspective," *Academy of Management Review* 32, no. 1 (2007): 257–272. Similarly, the exit cost caused by environmental legislation for oil distribution (cleaning costs associated with closing service stations) raises exit barriers (EU Commission, 1996). *See* Commission Decision Case IV/M.727 *BP/Mobil*, at §41.

75 Alberto Chonga and Gianmarco León, "Barriers to exit," *Economics Letters* 99, no. 1 (2008): 93–97. ([...] virtually all the empirical studies that deal with rigidity issues in international trade focus on goods and services and almost exclusively on the determinants and impact of barriers to entry at 93).

76 Justin O'brien, "Barriers to Entry: Foreign Direct Investment and the Regulation of Sovereign Wealth Funds," *The International Lawyer* 42, no. 4 (2008): 1231-1257. Leora Klappera, Luc Laevena and Raghruram Rajan, "Entry regulation as a barrier to entrepreneurship," *Journal of Financial Economics* 82, no. 3 (2006): 591–629. Nauro F. Campos, and Mariana Iootty, "Institutional barriers to firm entry and exit: Case-study evidence from the Brazilian textiles and electronics industries," *Economic Systems* 31, no. 4 (2007): 346–363. *See*, more generally, on the growth impact of "competition-enhancing" reforms that reduce barriers to entry. *See* Philippe Aghion, and Mark Schankerman, "On the Welfare Effects and Political Economy of Competition-Enhancing Policies," *The Economic Journal* 114, no. 498 (2004): 800–824. Büttner B, "Entry barriers and growth," *Economics Letters* 93, no. 1 (2006): 150–155.

77 Mike W. Peng, Yasuhiro Yamakawa, and Seung-Hyun Lee, "Bankruptcy Laws and Entrepreneur-Friendliness," *Entrepreneurship Theory and Practice* 34, no.3 (2010): 517–530. "Little research in the entrepreneurship literature has examined exit barriers such as bankruptcy laws" at 519.

78 Joseph E. Stiglitz, Juistin Yifu and Célestin Monga, "The rejuvenation of industrial policy," Working Paper Series 6628 (The World Bank, 2013).

79 Dani Rodrik, "Industrial Policy for the Twenty-First Century," Working Paper Series RWP04-047 (Harvard-KSG Faculty Research, 2004).

80 *Id.*

81 *Id.*

82 Paul Seabright, "National and European Champions - Burden or Blessing?," *CESifo Forum* 6, no. 2 (2005): 52-55. Ifo Institute for Economic Research at the University of Munich.

83 Will Jennings, "Executive politics, risk and the mega-project paradox," *Executive Politics in Times of Crisis*, ed. Martin Lodge and Kai Wegrich (Basingstoke, GB, Palgrave Macmillan, 2012), 239-263. Flyvbjerg, B., N. Bruzelius, and W. Rothengatter, *Megaprojects and Risk (*Cambridge University Press, 2003), 218. The reasons behind such failures revolve around basic principal-agent issues (Myddelton, 2007). First, unlike shareholders, Governments are not investing their money in such projects. Second, Governments are only accountable "every four or five years on a whole miscellany of past actions." Finally, the costs of the projects are diffused over a large number of electors, so that the losses may be perceived as so scattered that there are no incentives for lobbying the Government against.

84 David Myddelton, "They Meant Well. Government Project Disasters," *Institute of Economic Affairs Monographs,* no. 160 (2007): 244.

85 *Id.*

86 Seabright, *supra* note 82.

87 "How Lou Gerstner Got IBM To Dance", *Forbes*, November 11, 2002, http://www.forbes.com/2002/11/11/cx_ld_1112gerstner.html.

88 Mario Mariniello, "Foreign takeovers need clarity from Europe," *Bruegel Policy Brief,* no. 861 (2014).

89 The *GE/Alstom* transaction was eventually cleared by the European Commission on 8 September 2015. *See* http://europa.eu/rapid/press-release_IP-15-5606_en.htm.

90 *See* Council Regulation (EC) No. 139/2004 of 20 January on the Control of Concentrations Between Undertakings, (2004) OJ L24/1.

91 Doubts remain on whether Alstom will keep or sell its on-shore wind activities.

92 Not to a point, though, where GE would refuse to sign the deal. This barrier to exit does not matter as much for GE, who clearly seeks to expand in energy, than for Alstom, who seeks to leave the energy sector.

CLASSIC

Microsoft after Fifteen Years

Keith N. Hylton [1]

I. INTRODUCTION

United States v. Microsoft Corp. (Microsoft III)[2] is now fifteen years old, and that I would write such a long introduction to a reprint of significant portions from the opinion is a sign its significance has not died out. Just the opposite, I think it will become more significant in the near future, and not only because of its impact on U.S. antitrust law. The decision lays the groundwork for international enforcement of antitrust in high technology markets, at least as we have come to know them, and this is likely to continue to be significant for the foreseeable future.

As for U.S. law, it has become increasingly clear that *Microsoft III* is the second most important monopolization decision after Learned Hand's *United States v. Alcoa*.[3] To be sure, *Alcoa* must and will always be the most important Section 2 opinion because it sets the foundational principles for modern (post-1945) monopolization law. Judge Hand overturned a doctrinal framework that had induced a passive approach to antitrust enforcement against dominant firms and replaced with a framework that enabled and encouraged aggressive antitrust enforcement.[4] *Microsoft* has had a comparatively limited impact,[5] but it clarifies and updates the monopolization standard and constrains judges, and in these senses fundamentally alters the law from *Alcoa*.

In addition to the comparison with *Alcoa*, I will emphasize aspects of the case that cannot easily be gleaned from reading the opinion. I will not focus on the economics, a topic that has received ample attention.[6] Instead, I will emphasize strategic decisions of the parties involved – Microsoft, the Justice Department, the courts – and especially the human frailties that drove this litigation forward and made it the public spectacle that it was. Most importantly, I will emphasize the aftermath of the decision – specifically, its effects on antitrust enforcement and doctrine. *Microsoft III* has provided the template for modern antitrust enforcement in technology markets, and its legacy cannot be evaluated without taking into account its enormous impact on international antitrust.

II. THE LITIGATION: A QUICK SUMMARY

The Department of Justice's antitrust litigation against Microsoft began as a rather narrow and technical complaint about the firm's licenses with original equipment manufacturers – makers of computer hardware such as personal computers and laptops.[7] Microsoft required these firms to pay a license fee for every unit they sold, whether or not the unit incorporated Microsoft's operating system. The efficiency rationale for this is easy to see: software being easy to copy, and Microsoft's system being nearly ubiquitous at the time, it was more efficient for Microsoft and the original equipment manufacturer to assume that each unit had Microsoft's system installed rather than set up a costly monitoring and verification system. Still, the agreement had the effect of impeding rival operating systems; if the equipment manufacturer was going to have to pay for the Microsoft operating system whether he had installed it or not, then why would he consider installing a rival system? This dispute, known as *Microsoft I*,[8] ended quickly with a consent decree in which Microsoft agreed to stop seeking the per-processor license in its contracts.

Even this "preliminary skirmish," to use the description of Page and Lopatka,[9] reveals much about the core economic issues in the Microsoft litigation. The per-processor license agreement had an efficiency rationale, but it also posed a risk of harm to consumers by excluding competition. Rule of reason analysis would require consideration of both effects. It is possible that consumers were better off under the agreement because of the substantial costs of monitoring. These straightforward and yet empirically uncertain tradeoffs between efficiency and consumer harm would continually reappear in the Microsoft and related spin-off antitrust cases following *Microsoft I*.

Justice's litigation against Microsoft soon mushroomed into a more complex case centering on Microsoft's contractual and technological integration of its Internet browser with its operating system. First, Justice tried to enjoin, as a breach of the terms of the consent decree from *Microsoft I*, Microsoft's contractual requirement that original equipment manufacturers that license its operating system also license its browser. District Judge Thomas Penfield Jackson sided with Justice and issued an injunction, but it was overturned by the D.C. Circuit Court of Appeals with a stern rebuke in *Microsoft II*.[10]

The technological integration case, *Microsoft III*, was initiated in Judge Jackson's court shortly before the decision in *Microsoft II*. The disadvantaged rival in both cases was Netscape, the maker of a once popular stand-alone Internet browser. This time the Justice Department framed its case on a broader plane and expanded it, after hiring David Boise to manage the litigation, to include a smorgasbord of additional charges.

The core theory of the complaint was that Microsoft had suppressed the development of "middleware" as a competitive threat to its operating system monopoly. Middleware, a product category defined by Justice for its case against Microsoft, consisted of software applications that could, in theory, develop into substitutes to an operating system. Netscape and Sun's Java were offered as examples of such middleware, and also victims of Microsoft's anticompetitive conduct. In addition to this core theory, Justice augmented its complaint to include various contractual provisions with original equipment manufacturers, Internet service providers, software firms, Apple, Intel, and others that allegedly suppressed competition, again all to maintain Microsoft's dominance in the operating system market. Boise, working with state attorneys general, set up a veritable ecosystem of consultants, many paid through the offices of the state attorneys general, who spent countless hours combing through Microsoft's contracts to find provisions that could be cast as anticompetitive.[11]

Judge Jackson found Microsoft guilty of violating Section 2 for maintaining its operating system monopoly and for attempting to monopolize the browser market, and of violating Section 1 for tying the browser to the operating system. He ordered the company to be split into an operating system company and a software applications company. The D.C. Circuit upheld the finding that Microsoft had monopolized the operating system market, reversed the attempted monopolization holding, and remanded the decision on tying.

The trial was not time-consuming as antitrust cases go; Judge Jackson had put the case on a 76-day fast track resulting in detailed factual findings that greatly constrained the discretion of the D.C. Circuit to overturn the central findings of illegality. Still, the trial, and the events leading up to it, seemed to take much more time because of the unusual media attention the case had garnered.[12]

III. HUMAN FRAILTIES AND LITIGATION

Perhaps the main reason the trial captured so much attention was its narrative of the rise of the Bill Gates Empire. Justice presented a case about a fellow who had engaged in perpetual and intense battles with competitors over every scrap of turf, and seemed almost paranoid in managing Microsoft's strategy. He had made himself the richest man in the world, as a result of his persistently anticompetitive conduct.[13] Now he had gone too far, and the law would cut him down to size; a familiar theme in literature. This simple narrative was barely beneath the surface in public descriptions of the case, and was surely the reason it captured so much attention as the trial progressed.

Moreover, the Bill Gates narrative not only captured the public's attention, it also helped propel the litigation forward, as Page and Lopatka have noted.[14] It fueled lobbying efforts directed toward enforcement agencies, and eventually became the core of the government's case against Microsoft; the part that appealed directly to the basic human tendency to see disputes in moral colors, as good versus evil.

Along with the manufactured Gates narrative, there were some genuine sensational events played out in the litigation that were both worthy of attention from artists and at the same time important in driving the litigation. In addition to the dramatic rise and downfall theme, there is the conflict between human frailty and the demands of judging, captured in three important vignettes.

The first vignette involves District Judge Stanley Sporkin, and illustrates the behavioral tendency to attribute improper motives and to seek punishment, even when no personal profit – and only personal loss – can result from it.[15] Frustrated with the passive position he was forced to take as a judge reviewing an antitrust settlement under the Tunney Act, Sporkin castigates Justice for not prosecuting Microsoft for other bad deeds, and refuses to approve the settlement in the first litigation involving the per-processor licenses. In response, the D.C. Circuit disqualified him from hearing the case.[16] However, the clash between Sporkin's view and Justice's would be short lived. He had a firmer grasp of the ultimate prosecution narrative than Justice did at that time. Sporkin's view that this was a story of good against evil would become the prosecution narrative in *Microsoft III*. In addition, Sporkin's diatribe surely signaled to Justice that there was a broader attack on Microsoft that might be persuasive to some judges.

The second vignette, involving Richard Posner, illustrates obstacles that status perception can create in the dispute resolution process. Judges, as humans, are status conscious, and the perception of high status generates an expectation of deference.[17] When the expected deference is not forthcoming, conflict arises. Posner was tasked by Judge Jackson with mediating a settlement before trial got under way. But the mediation process was severely hobbled by the state attorneys general, who kept upping their demands as Justice and Microsoft came closer to a set of terms on which they could agree. Posner did not see this as a case of good versus evil, but found himself in the unusual position, as a judge, of having to persuade a litigant in his court (the state attorneys general) that his stance on the relevant legal and policy matters should prevail. Like Sporkin, he was hemmed into a passive position, not by the law, but by the nature of the role he had accepted as mediator. The settlement talks broke down, with Posner, according to a whispered account, exposing his frustration with the state attorneys general by referring to them as "assholes" in his last conference call with them.

First and Gavil,[18] unfairly in my view, pin the blame on Posner for the mediation breakdown, when the efficient cause was the conduct of the state attorneys general. But there is an element of truth in First and Gavil, given that Posner had stepped into a position that was inconsistent with his perceived status as judge and reputation as the country's leading authority on antitrust law. A mediation specialist would have been more successful; unburdened by the status perception of a judge, he would have pushed or cajoled the parties to make whatever tradeoffs were necessary to close the deal whether or not those concessions were consistent with what the law or reasonable economic judgment required. In other words, if Posner had not been the initial mediator, the trial in Judge Jackson's court probably would have been avoided.

The final vignette in this series illustrating the conflict between judging and human emotions in the Microsoft litigation involves Judge Jackson. It was revealed after the trial that he had spoken uncharitably about Microsoft to reporters to whom he had granted interviews about the case, even as the trial was proceeding.[19] His remarks indicate that he had fully absorbed Sporkin's personification thesis that this was a battle between good and evil,[20] and evil could carry out its designs in many unexpected ways unless sternly shackled. Unlike Sporkin, Jackson was not forced into passivity; he could use findings of fact to bind the hands of an appellate court. The opportunity to do so had been amply provided Boise's team, hoovering up, partly through their reticulated system of consultants, mounds of anecdotes, contractual provisions, and emails that could be cast as reflecting an anticompetitive intent. And Jackson knew that he might face an appellate panel, like that in *Microsoft II*, deeply skeptical of the core theory of Justice's case. The result was his heavily fact-based opinion finding numerous anticompetitive acts coupled with no evidence in the record of any corresponding procompetitive justifications offered by Microsoft. Still, the core of the case was Microsoft's technological integration decision, and this is the aspect that still carries a unique reverberation through antitrust enforcement today.

IV. LEGACY AND AFTERMATH

In *Microsoft III*, the D.C. Circuit upheld Jackson's finding that Microsoft had violated Section 2 of the Sherman Act by unlawfully maintaining its monopoly in the operating system market. Microsoft's unlawful maintenance actions consisted of technologically integrating its browser into its operating system, obstructing the development of an independent Java platform on the Microsoft operating system, and using restrictive licenses with original equipment manufacturers and other firms. Justice had skillfully presented numerous actions falling under these categories as part and parcel of an overall scheme to exclude the development of competition in the operating system market.

In a statement of the legal standard that reflects perhaps the most important legacy of Microsoft III, the D.C. Circuit said that if the plaintiff establishes an anticompetitive effect, and if the defendant establishes a nonpretextual procompetitive justification, the burden would lay with the plaintiff to prove that the anticompetitive harm outweighed the procompetitive benefit.

Applying this balancing test, the court found that Microsoft had violated Section 2 through several acts, the most important of which was the technological integration of Internet Explorer with the Microsoft operating system. However, the court also reversed Jackson's finding that Microsoft had violated Section 1 by "tying" the browser to the operating system.

Viewed in economic terms, the Section 2 and Section 1 decisions on integration are inconsistent. We are talking about the same facts – a unilateral decision by Microsoft to integrate the browser with the operating system. If the antitrust laws rest on a solid economic foundation, simply changing the label from Section 2 to Section 1 should not lead to a different result. If the existence of several efficiencies might justify a court in finding that, under Section 1 tying law, the integration of the browser with the operating system was not unreasonably anticompetitive, then the very same efficiencies should point to the conclusion that under Section 2 monopolization law, integration was not anticompetitive. Whatever one thinks of the merits of the decision, it is a glaring example of the need for consistent principles in antitrust. The same set of facts should not generate entirely different answers from the court depending on the label or the pleading strategy of the plaintiff. More inconsistencies are revealed as you look more closely at the Section 2 holding.

However, the broader legacy of *Microsoft III* has nothing to do with its inconsistencies. The broader legacy consists of two counterbalancing features of the decision: one providing a gloss on the judge's scope of authority under the Sherman Act that is circumscribed in comparison to the framework of *Alcoa*, and the other its application of the balancing test to a matter of technological product design, an apparent volte-face from *Microsoft II* and preexisting law.

On the circumscribing effect of *Microsoft III*, return to Judge Hand's *Alcoa* decision, which established the modern legal standard under Section 2. Hand held that a dominant firm violates Section 2 of the Sherman Act when it acquires or maintains a monopoly through means not attributable to luck, or superior skill, foresight, and industry. In addition, Hand held that although the law punishes conduct that monopolizes, the mere act of setting a price or producing as a monopolist should be considered a violation of the antitrust laws because it was equivalent in economic effect to a group of firms setting a common, cartel price. Hence, the premise that mere size was not unlawful, adopted in a string of early Supreme Court Section 2 cases, served mainly as a rule for channeling prosecutorial resources rather than a foundational position on the proper scope of the statute's prohibitions. Lastly, Hand held that efficiency was one of several ends sought by the statute, but by no means the most important, and that Congress in enacting the statute assumed that efficiency could be sacrificed in order to obtain a more atomistic market and political structure.

In combination, these three propositions of *Alcoa* give the judge enormous power and discretion under the statute to engage in economic and, to some degree, social engineering, all under a set of loosely connected legal principles. A judge need not worry about the efficiency consequences of his decision; it was his prerogative, under the law, to determine the structure of the market, so long as his vision was consistent with that of the statute's framers. Judges would not passively let economic forces determine outcomes under the statute, but would control those forces through the statute.

Microsoft III, in comparison, represents a sea change in the judiciary's view of its authority under the statute.

The Microsoft III doctrine assumes that efficiency is a central concern of the statute, and instructs judges to balance efficiencies against anticompetitive harms in determining whether the statute has been violated. The judge is not permitted to subordinate efficiencies to other concerns, such as economic or political atomism.

The balancing test of *Microsoft III* is a further constraint on the discretion of the judge. The non-passive acquisition test of *Alcoa* put few constraints if any on the judge's discretion to find that a certain course of conduct by a dominant firm violates the statute. *Alcoa* itself is an example of this nearly boundless discretion: Hand found Alcoa in violation of Section 2 because it had acted too aggressively in entering and supplying new geographical markets and product niches – conduct that could easily serve to illustrate the sort of superior foresight and industry that was in theory immunized under Hand's interpretation of the statute. In contrast to the non-passive acquisition standard of *Alcoa*, the balancing test of *Microsoft III* enables the defendant to offer proof that its conduct introduced efficiencies or procompetitive benefits to consumers.

All of this is progress because it brings some measure of consistency and predictability to Section 2 law and enforcement. The Justice Department is less likely, going forward, to bring cases that clearly violate the *Microsoft III* test because of the presence of substantial efficiencies created by the defendant's conduct.[21] Courts are far less likely to cite *Alcoa* for a ruling that cannot be justified on efficiency grounds.

The other substantial part of *Microsoft III* legacy is its application of Section 2 to a case of technological integration. This is obviously of great importance for the future because much of modern technology involves the integration of various conceptual functions, mainly through the use of software. Phones have become computers, and cars are rapidly becoming computers too.

Microsoft III's application of the balancing test to a dominant firm's decision to technologically integrate two functions has gone a considerable distance toward obscuring or at least seriously compromising two established doctrines of antitrust law: limitations on a dominant firm's duty to deal, and the general policy exempting technological integration from the test of *Alcoa*. The limitations antitrust law puts on a dominant firm's duty to deal are best articulated in the Supreme Court decisions *Trinko*[22] and *linkLine*.[23] As between the two, *Trinko* provides the more nuanced treatment of the doctrine in this area. Justice Scalia, in *Trinko*, held that Verizon's reluctance to aid rival phone service providers in their efforts to connect to its telecommunications infrastructure did not violate Section 2 because there was insufficient evidence that Verizon's actions were motivated solely by intent to exclude competition. *LinkLine* expands on *Trinko*'s holding by articulating a general rule that a dominant firm does not have a general duty to deal with a rival. The lesson of the two cases is that in the absence of evidence of a specific intent to exclude competition, the dominant firm has no duty to aid a rival under Section 2 of the Sherman Act. Evidence that the dominant firm had an efficiency motivation that might justify its exclusionary act should be sufficient under *Trinko* to avoid a finding of a specific intent to exclude. Certainly, the absence of a duty to deal with a rival implies that a court should not apply a balancing test to the evidence suggesting exclusion when efficiencies are present. But this clashes with *Microsoft III*, where there were obvious efficiency justifications for the technological integration, detailed with admirable care in the court's analysis of the technological tying issue, and yet the court asserted that it would be appropriate to balance anticompetitive harms against efficiencies.

The other strand of antitrust compromised by *Microsoft III* is the doctrine that technological tying (or integration) does not violate the antitrust laws in the absence of evidence indicating a specific intent to exclude competition.[24] One might view this as a rather artificial rule given that contractual tying has been subject to the antitrust laws for a long time. Why distinguish technological and contractual tying?[25] Why not treat tying of any sort under a common legal test? The reason for distinguishing technological and contractual tying is to remain consistent with the general maxim, recognized in many antitrust opinions, that courts are not authorized by the Sherman Act to serve as regulatory agencies.[26] Judges are not empowered by the statute to oversee product design, pricing, and output decisions. However, applying a balancing test to technological tying puts courts precisely in the position of regulating product design.

These decisions on the duty to deal and technological tying have had an enormous impact on antitrust enforcement in the United States and globally. The theories adopted by the D.C. Circuit in *Microsoft III* were adopted by the European Commission in its decision on Microsoft's integration of its media player,[27] leading to a requirement that Microsoft offer for sale in Europe a version of its operating system that did not technologically incorporate the media player. The European Commission is obviously free to adopt its own antitrust laws, but *Microsoft III* offered a blueprint for antitrust enforcement theories in the technology industry, and permitted Europe's antitrust regime to avoid the obvious scrutiny that would accompany the adoption of antitrust doctrines noticeably inconsistent with American law.

The seemingly never-ending entanglement of Google with the European antitrust authorities is also, somewhat ironically, derivative of *Microsoft III*. The irony here is that Google sought early to distance itself from Microsoft by adopting "Don't Be Evil" as a marketing theme, a not-so-subtle reference to the antitrust troubles of Microsoft. Now there are allegations that Google may have engaged in evil practices analogous to those condemned in *Microsoft III*. Google's entry into vertical search services (restaurants, hotels, etc.) put it into direct competition on its own search platform with other firms that had specialized in vertical search "sub-platforms" (e.g. Yelp). The rival sub-platforms claim that Google distorts or biases its rankings process to push them below Google's own sub-platforms, just as Microsoft allegedly made it difficult for rival applications such as Netscape to compete against Microsoft applications on its own platform (the operating system). Arguments have been made to distinguish Google from Microsoft – such as that competition is only "one click away" in the case of Google – but the general features of the antitrust problem are the same in the two cases. The doctrine of *Microsoft III* applies rather easily to Google's conduct toward the rival sub-platforms. The FTC applied the doctrine and closed its investigation of Google after concluding that the efficiencies likely outweighed the anticompetitive harms. The European Commission has not reached a similar conclusion, and is less likely to do so because of its more skeptical view of the weight that should be accorded to efficiencies.[28] However, at this time the Google search-bias case in the European Union meanders on with no clear resolution. At the same time, the Russian antitrust authorities have found that Google violated their antitrust laws by selling the Android platform in Russia with some of its own software applications bundled by default.[29]

I predict that *Microsoft III* will continue to have a greater effect on developing international antitrust enforcement as time passes. Integration of software functionality is now the most prominent type of technological innovation observed. Although the number of software patents awarded has declined recently as a result of *Alice Corp. v. CLS Bank International*,[30] a large share of new patents are software related – indeed, in 2011 new software patents outnumbered other types of new patent.[31] As many of new software-integrated products hit the markets and travel internationally, the disputes generated in *Microsoft III* will reappear. Local software firms will argue that the maker of the platform – whether a smart phone, a smart car, or a smart shirt – should have a legal duty to enable the local firm to install its software on the platform without facing anticompetitive obstacles.

In the end, *Microsoft III* has delivered a rather strange legacy. On one hand, it has jettisoned the bewildering language and nearly unfettered judicial discretion of the *Alcoa* standard, replacing it with a more predictable and constraining doctrine. That is an unambiguously desirable change. On the other hand, its holding on technological integration has unleashed a wave of antitrust constraints in the technology sector that has become especially foreboding for American firms that have a global reach, and promises to become much knottier in the future as software integrated products multiply. In other words, *Microsoft III* has bound the hands of American judges, and at the same time encouraged international enforcement authorities, and the protectionist factions who lobby those authorities, to pick apart American technology firms once they venture from home. While it is unlikely that the international antitrust attacks will drastically reduce innovation incentives in the United States, they are likely to remain a significant drag for years to come.[32]

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2 United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001).

3 United States v. Alcoa, 148 F.2d 416 (2d Cir. 1945).

4 Keith N. Hylton, Antitrust Law: Economic Theory and Common Law Evolution (Cambridge: Cambridge University Press, 2003), 189-194.

5 David S. Evans, Albert L. Nichols and Richard Schmalensee, "U.S. v. Microsoft: Did Consumers Win?," Journal of Competition Law and Economics 1, no. 3 (2005): 497-529

6 Timothy Bresnahan, "The Economics of the Microsoft Case," Working Paper No. 232, Stanford Law and Economics, 2002, http://ssrn.com/abstract=304701 or http://dx.doi.org/10.2139/ssrn.304701;
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7 United States v. Microsoft, 159 F.R.D. 318 (D.D.C. 1995), and 56 F.3d 1448 (D.C. Cir. 1995)

8 United States v. Microsoft Corp., 56 F.3d 1448 (D.C. Cir. 1995).

9 William H. Page and John E. Lopatka, The Microsoft Case: Antitrust, High Technology, and Consumer Welfare (Chicago: University of Chicago Press, 2007).

10 United States v. Microsoft Corp., 147 F.3d 935 (D.C. Cir. 1998).

11 During the Microsoft litigation, I asked one law professor who claimed to be consulting for the government on the litigation precisely what the professor did. Answer: "the state attorney general sends us copies of Microsoft's contracts, and we comb through them to identify anticompetitive stuff, and bill the state for the time." I was given the impression that this was a lucrative endeavor for the professor.

12 On the media attention and broader political context of the Microsoft litigation, see William H. Page and John E. Lopatka, "The Microsoft Case as a Political Trial," Political Trials ed. Jens Meierhenrich and Devin Pendas (Cambridge: Cambridge University Press, 2015).

13 Even some economists adopted this narrative; see Bresnahan, Timothy, "The Right Remedy," Working Paper No. 233 (Stanford Law and Economics Olin, 2002), http://ssrn.com/abstract=304702 or http://dx.doi.org/10.2139/ssrn.304702.

14 Page and Lopatka, supra note 12.

15 This tendency is reflected in the Ultimatum Game. See Rachel T. A. Croson, "Information in Ultimatum Games: An Experimental Study," Journal of Economic Behavior & Organization, 30, no.2 (1996): 197- 209. Hessel Oosterbeek , "Cultural Differences in Ultimatum Game Experiments: Evidence from a Meta-Analysis," Experimental Economics 7(2004): 171-72.

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17 Robert H. Frank, Choosing the right pond: Human behavior and the quest for status (New York :Oxford University Press, 1985); Ori Heffetz and Robert H. Frank, Preferences for status: evidence and economic implications, ed. Jess Benhabib, Alberto Bisin, Matthew Jackson (Handbook of Social Economics, 2010), 69-91.

18 Andrew I. Gavil and Harry First, The Microsoft Antitrust Cases: Competition Policy for the Twenty-First Century, (Massachusetts: MIT Press, 2014).

19 Ken Auletta, "Final Offer," New Yorker (2001), http://www.kenauletta.com/finaloffer.html.

20 On the behavioral tendency to personify, see Nicholas Epley, Adam Waytz, and John T. Cacioppo, "On Seeing Human: A Three-Factor Theory of Anthropomorphism," Psychological Review 114 (2007): 864

21 United States v. Syufy Enterprises, 903 F.2d 659, 667 (9th Cir. 1990) (criticizing government's use of the Alcoa doctrine to justify its refusal to give weight to efficiencies in a monopolization case).

22 Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004).

23 Pacific Bell Telephone Co. v. linkLine Communications Inc., 555 U.S. 438 (2009).

24 Response of Carolina, Inc. v. Leasco Response, Inc., 537 F.2d 1307 (5th Cir. 1976).

25 United States v. Microsoft Corp., 87 F. Supp. 30 (D.D.C. 2000) in Brief of Lawrence Lessig as Amicus Curiae, (2000): 98-1233.

26 See Supra note 21 at 408 ("Enforced sharing also requires antitrust courts to act as central planners, identifying the proper price, quantity, and other terms of dealing--a role for which they are ill suited.")

27 Case T-201/04, Microsoft Corp. v. Commission, 17 September 2007, ECR II-3601, (CFI Decision 2007).

28 Keith N. Hylton, "Antitrust Enforcement Regimes: Fundamental Differences," The Oxford Handbook of International Antitrust Economics, ed. Roger D. Blair and Daniel Sokol (Oxford: Oxford University Press, 2014).

29 Olga Razumovskaya and Alistair Barr, "Google Found Guilty of 'Abusing Dominant Market Position' in Russia", Wall Street Journal (2015) http://www.wsj.com/articles/google-found-guilty-of-abusing-dominant-market-position-in-russia-1442250025. The European Union currently is investigating this issue, and an antitrust class-action has been filed in the United States. For an analysis, see J. Gregory Sidak, "Do Free Mobile Apps Harm Consumers?" San Diego Law Review, Forthcoming. (2015), http://ssrn.com/abstract=2507905 or http://dx.doi.org/10.2139/ssrn.2507905.

30 Alice Corp. Pty. Ltd. v. CLS Bank Int'l, 573 U.S. __, 134 S. Ct. 2347 (2014).

31 See Government Accountability Office (GAO), "Intellectual Property: Assessing Factors That Affect Patent Infringement Litigation Could Help Improve Patent Quality" Report to Congressional Committees, August 2013 GAO-13-465, (United States GAO) 12, http://www.gao.gov/products/GAO-13-465.

32 The innovation implications of Microsoft III are fully explored in Daniel F. Spulber, "Competition Policy and the Incentive to Innovate: The Dynamic Effects of Microsoft v. Commission", 25 Yale J. Reg. 247 (2008). However, Spulber does not emphasize the public choice implications of Microsoft III. At the time of the Microsoft litigation, arguments were made that Microsoft's conduct had deterred innovation in the software industry. Those allegations were empirically examined by Josh Lerner, who found no evidence to support them, see Josh Lerner, "Did Microsoft Deter Software Innovation?" (2001), SSRN: http://ssrn.com/abstract=269498 or http://dx.doi.org/10.2139/ssrn.269498.