CPI's Asia Column Presents:

Global Antitrust Institute's Comment on NDRC Gains and Fines

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This comment is submitted in response to the National Development and Reform Commission (NDRC) of the People's Republic of China's public consultation on the Proposed Revisions to the Guidelines of the Anti-Monopoly Commission of the State Council on Determining the Illegal Gains Generated from Monopoly Conduct and on Setting Fines (Draft Guidelines). We submit this comment based upon our extensive experience and expertise in antitrust law and economics.[1]

We commend the NDRC for inviting comments on its recently released Draft Guidelines, and for endeavoring to improve transparency and enhance legal certainty with regard to the application of anti-monopoly administrative penalties.

We respectfully recommend that the Draft Guidelines be revised to limit the application of disgorgement (or the confiscating of illegal gain) and punitive fines to matters in which: (1) the antitrust violation is clear (i.e., if measured at the time the conduct is undertaken, and based on existing laws, rules, and regulations, a reasonable party should expect that the conduct at issue would likely be found to be illegal) and without any plausible efficiency justifications; (2) it is feasible to articulate and calculate the harm caused by the violation; (3) the measure of harm calculated is the basis for any fines or penalties imposed; and (4) there are no alternative remedies that would adequately deter future violations of the law. In the alternative, and at the very least, we strongly urge the NDRC to expand the circumstances under which the Anti-Monopoly Enforcement Agencies (AMEAs) will not seek punitive sanctions such as disgorgement or fines to include two conduct categories that are widely recognized as having efficiency justifications: unilateral conduct such as refusals to deal and discriminatory dealing and vertical restraints such as exclusive dealing, tying and bundling, and resale price maintenance.

We also urge the NDRC to clarify how the total penalty, including disgorgement and fines, relate to the specific harm at issue and the theoretical optimal penalty. As explained below, the economic analysis determines the total optimal penalties, which includes any disgorgement and fines. When fines are calculated consistent with the optimal penalty framework, disgorgement should be a component of the total fine as opposed to an additional penalty on top of an optimal fine. If disgorgement is an additional penalty, then any fines should be reduced relative to the optimal penalty.

Lastly, we respectfully recommend that the AMEAs rely on economic analysis to determine the harm caused by any violation. When using proxies for the harm caused by the violation, such as using the illegal gains from the violations as the basis for fines or disgorgement, such calculations should be limited to those costs and revenues that are directly attributable to a clear violation. This should be done in order to ensure that the resulting fines or disgorgement track the harms caused by the violation. To that end, we recommend that the Draft Guidelines explicitly state that the AMEAs will use economic analysis to determine the but-for world, and will rely wherever possible on relevant market data. When the calculation of illegal gain is unclear due to a lack of relevant information, we strongly recommend that the AMEAs refrain from seeking disgorgement.

THE ECONOMICS OF PENALTIES

Economic theory teaches that penalties should be set at a level sufficient to induce offenders to internalize the full social cost of their illegal conduct.[2] From the perspective of a market participant and their ex ante incentives to commit an antitrust violation, there is no

meaningful economic distinction between a monetary penalty that is remedial (such as disgorgement) or punitive (such as a fine). In shaping their behavior to align with legal rules, market participants care only about the expected penalty and not about whether the expected penalty is labeled as "disgorgement," "restitution," "fines," or some other legal term of art that connotes the payment of money.

In a world with imperfect detection and punishment, profit-maximizing market participants will need to face a potential damage award calibrated such that the gains from engaging in the prohibited conduct—the profits that accrue as a result of the anticompetitive behavior—are less than or equal to the expected penalty at the time the firm decides to engage in the challenged conduct. The expected penalty equals the magnitude of total penalty imposed multiplied by the probability of punishment. The probability of punishment includes the potential for both private and public enforcement actions. If all anticompetitive conduct is likely to be detected by private persons with standing to sue or a public antitrust enforcement body and penalized at a level exactly equal to its social cost, then any additional penalties are unnecessary to deter antitrust violations. If the likelihood of detection is less than 100%, then penalties that exceed the social cost of the violation may be warranted to effectively deter future violations.

When only type II errors or false negatives are possible (when firms that have violated the law escape punishment) the optimal penalty, including all sources of monetary fines, disgorgement, and civil recoveries, should equal the harm caused by the violation divided by the probability of punishment. Optimal deterrence theory suggests, then, that the optimal total amount of monetary penalties in cases when conduct is most likely to be detected should be less than in cases when anticompetitive conduct is likely to go unnoticed. In cartel cases, the clandestine nature of the agreements may warrant a larger total penalty of confiscating illegal gains and imposing fines, than more easily detected, but harmful single-firm violations in order for the penalty to have a sufficient deterrent effect. In the case of price fixing cartels and other horizontal conspiracies, we can reasonably expect that regulators and private litigants do not ferret out and challenge every illegal conspiracy that exists because such conspiracies are clandestine by their very nature.[3] On the other hand, most examples of potentially harmful single-firm conduct are open and notorious. For example, upstream input suppliers to downstream monopolists are keenly aware of any restraints on distribution put in place by a monopolist and, to the extent the input supplier is harmed by the restraint, will generally have the appropriate incentive to challenge the conduct.

Cartels cases can also be distinguished in terms of the costs of type I error costs (costs resulting from false positives, or when firms engaged in efficient, welfare increasing conduct are erroneously penalized). Because naked pricing fixing cartels lack any offsetting efficiency benefits, the costs of type I error in such enforcement actions are close to zero. In contrast, when evaluating conduct that can be efficient and benefit consumers in some contexts and harm competition and consumers in others, the costs of type I errors can be large and generate the possibility that large penalties may deter lawful and procompetitive conduct. The potential for significant type I error costs lower the level of optimal penalties relative to settings where these costs are small.

In general, any enforcement system should seek to minimize the total social costs associated with implementing the policy.[4] These costs include the costs of type I error, type

II error, and the costs associated with administering the antitrust enforcement system. Antitrust scholars have relied upon this decision theoretic framework to facilitate identification of antitrust rules that best promote competition and protect consumer welfare.[5] The U.S. Supreme Court has recognized the limitations the courts face in distinguishing between pro- and anticompetitive conduct in antitrust cases and emphasized the high rate of type I error in monopolization cases in particular.[6] The U.S. Supreme Court has also expressed concerns, originally explained in Judge Frank Easterbrook's seminal analysis, that the cost to consumers arising from type I errors might be greater than those attributable to type II errors because "the economic system corrects monopoly more readily than it corrects judicial errors."[7]

In particular, the cost of overdeterrence is greater when the economic literature has identified and substantiated many possible efficiency justifications for the conduct alleged to violate the antitrust laws. For example, economists have long understood that unilateral conduct (e.g., refusals to deal or discriminatory dealing) and vertical restraints (e.g., exclusive dealing, tying and bundling, and resale price maintenance) are frequently procompetitive.[8] This increases the risk of type I error as courts have difficulty distinguishing between procompetitive and anticompetitive uses.

Further, competition law violations involving single firm conduct are likely to be detected. The economic analysis of penalties implies that optimal deterrence when the probability of detection is high does not require multiple or supracompensatory damages or sanctions.[9] For example, vertical restraints such as resale price maintenance or exclusive dealing necessarily involve customers of the alleged monopolist, and thus the probability of detecting the underlying conduct is near 1. The probability of detection is also very high in other instances of alleged monopolization involving overt acts by the defendant. Punishing these types of violations with a combination of disgorgement and fines that exceed single damages is likely to discourage other firms from using similar arrangements, even when they would have welfare-enhancing and procompetitive benefits.

SPECIFIC RECOMMENDATIONS

I. Article 5—Concept of Illegal Gains

The Draft Guidelines appear to create a framework under which the primary remedy for violations of the Anti-Monopoly Act will be a fine calculated as a percentage of affected sales. Article 5 appears to create a presumption that confiscation of illegal gains will be an additional remedy if available. We are concerned that such a framework may undermine the AMEAs' stated goal of promoting economic welfare and economic efficiency by possibly overdeterring procompetitive conduct.[10] Article 5 also provides that the AMEAs can confiscate illegal gains "in relation to [the] China market" when such conduct occurs outside China. We respectfully recommend that the AMEAs apply this provision only in limited circumstances in order to avoid conflict with foreign laws and the possibility of duplicative penalties, which are likely to overdeter illegal conduct. We also recommend that the Draft Guidelines be revised to include clear conditions and concrete examples for when this provision would be applied.

Specifically, we respectfully recommend that the Draft Guidelines be revised as follows:

> The AMEAs will confiscate illegal gains of the undertaking generated from engaging in business activities in China when: (1) the violation of the law is clear (i.e., if measured at the time the conduct is undertaken, and based on existing laws, rules, and regulations, a reasonable party should expect that the conduct at issue would likely be found to be illegal) and without any plausible efficiency justifications; (2) there is a reasonable relationship between the harm caused by the violation and the measure of illegal gains; (3) there is a reasonable basis upon which to calculate the disgorgement payment; and (4) other remedies are unlikely to accomplish fully the purposes of the Anti-Monopoly Law. If the undertaking does not engage in economic activities within the territory of China, the AMEAs may, under certain exceptional circumstances, confiscate the illegal gains generated from the undertaking's economic activities in relation to China market.

II. Article 6—Major Factors to be Considered for Determining Illegal Gains

To ensure transparent and unbiased calculations, as well as the promotion of economic welfare, the AMEAs should ensure that qualified individuals conduct an economic analysis of the violation. Requiring economic analysis will aid the AMEAs in correctly identifying violations that are harmful to consumers and do not have efficiency justifications.

> When determining the illegal gains, the AMEAs will conduct economic analysis to evaluate the impact of the conduct at issue. The economic analysis will consider the change of price of the relevant product, the change of sales volume, the change of market shares of the undertaking in the relevant market, the change of profit margin as a result of the monopoly conduct, as well as characteristics of the industry concerned in determining the hypothetical competitive market for comparison to the actual market.

III. Articles 8-10

We recommend that Articles 8 and 9 be revised to explicitly require economic analysis to determine the hypothetical income/cost as opposed to basing calculations on "historical profit margins, profit margins in the industry, profit margins in the comparable market."

With respect to Article 9, which addresses the method for determining the amount of illegal gains in the form of reduced expenses, it is unclear whether this Article is limited to apply to matters involving monopsony and its associated welfare costs. If so, we recommend that the Article be revised to explicitly state that intention; if not, we recommend that the Article be deleted in its entirety as it would appear to erroneously count efficiencies as competitive harm.

Lastly, we recommend that Article 10 be revised as follows to eliminate double counting:

> Illegal gains can result from a combination of additional income and reduced expense, and such illegal gains should be taken into account in the economic analysis performed according to Articles 8 and 9.

IV. Article 12—Special Circumstances in Determining the Illegal Gains

For the following reasons, we respectfully recommend that subsections 1-3 of Article 12 be omitted in their entirety.

First, the determination of a "reasonable" fee is likely to be prone to false positives, identifying unreasonable rates that are in fact reasonable. In addition, undertakings are unlikely to be able to distinguish reasonable from unreasonable fees, making self-advisement difficult. Penalizing "unreasonable" fees by confiscation is likely to overdeter beneficial instances of fees.

Second, price discrimination may have procompetitive benefits, and as such should not be included as conduct punished by confiscating illegal gain. Price discrimination allows customers who would previously have been priced out of the market to purchase a good. The likely efficiency and procompetitive benefits of price discrimination are such that antitrust authorities should be more concerned with overdeterring price discrimination, not under-deterrence.

Lastly, using the lowest purchase price, or the highest sales price is highly unlikely to identify the price in the but-for world. When firms with market power are not allowed to price discriminate, economic theory suggests these firms will charge a higher price and limit output. Using the lowest purchase price or the highest sales price is likely to significantly overestimate illegal gains, excessively punishing conduct that might be beneficial to consumers.

In the alternative, and at the very least, we recommend that the NDRC clearly articulate its theory of competitive harm and the ways in which that competitive harm might be credibly measured.

V. Articles 13 and 14—Circumstances Where No Illegal Gains Might Be Found and Circumstances Where Illegal Gains Will Not Be Forfeited

We reiterate our recommendation to apply illegal gains only in circumstances when: (1) the antitrust violation is clear (i.e., if measured at the time the conduct is undertaken, and based on existing laws, rules, and regulations, a reasonable party should expect that the conduct at issue would likely be found to be illegal) and without any plausible efficiency justifications; (2) it is feasible to articulate and calculate the harm caused by the violation; (3) the measure of harm calculated is the basis for any disgorgement or penalties imposed; and (4) there are no alternative remedies that would adequately deter future violations of the law. In addition, when fines are calculated consistent with the optimal penalty framework, disgorgement should be a component of the total fine as opposed to an additional penalty on top of an optimal fine. If disgorgement is an additional penalty, then any fines should be reduced relative to the optimal penalty.

In the alternative, and at the very least, we strongly urge the NDRC to add the following two safe harbors from disgorgement to Article 14: (1) the undertaking engaged in unilateral conduct such as a refusal to deal or discriminatory dealing, including when the undertaking competes with the entity towards which the conduct is directed; and (2) the undertaking implemented a vertical restraint that has plausible procompetitive benefits.

Unilateral conduct such as refusals to deal and discriminatory dealings, including when directed at competitors, are likely to have procompetitive benefits such as providing incentives for firms to engage in the risky and costly research and development and entrepreneurial behavior that leads to innovation and economic growth. Indeed, forced sharing can deter innovation not only by the firm engaged in the conduct but also by rivals who might be encouraged to free ride instead of creating their own competing technology or

goods to the resulting benefit of consumers. In addition, as the U.S. Supreme Court has recognized, forced sharing, particularly among rivals, is "in some tension with the underlying purpose of antitrust law."[11]

Similarly, the overall body of evidence supports a fairly strong conclusion that vertical restraints very rarely result in anticompetitive effects and most often benefit consumers. One study, authored by a group of economists from the U.S. Federal Trade Commission (FTC) and Department of Justice's Antitrust Division in 2005, concludes that, although "some studies find evidence consistent with both pro- and anticompetitive effects . . . virtually no studies can claim to have identified instances where vertical practices were likely to have harmed competition."[12] Another study from 2009 concludes that, "it appears that when manufacturers choose to impose such restraints, not only do they make themselves better off but they also typically allow consumers to benefit from higher quality products and better service provision."[13] Finally, in a paper considering recent empirical evidence concerning the competitive effects of vertical restraints, an FTC economist concludes that, "with few exceptions, the literature does not support the view that [vertical restraints] are used for anticompetitive reasons" and that vertical restraints "are unlikely to be anticompetitive in most cases."[14]

VI. Article 18—Definition of "the Sales Value"

Article 18 would allow the AMEAs, under certain circumstances, to calculate fines based on the sales value generated both within and outside China. We respectfully recommend that this provision be omitted in its entirety to avoid conflict with foreign laws and the possibility of duplicative penalties, which are likely to overdeter illegal conduct.

VII. Articles 20-28—Setting of Fines

Articles 20-28 set forth various percentages for different types of Anti-Monopoly Law violations. We strongly urge that these provisions be revised to explicitly state how the various percentages relate to the harm caused by the violation. We also strongly urge the NDRC to make explicit that the total criminal fine imposed will include any disgorgement amount or, if disgorgement is an additional penalty, then any fines will be reduced relative to the optimal penalty.

Lastly, we recommend that Article 28 be revised as follows to omit factors that are predominantly measures of market structure, which are poor measures by which to discern the severity of conduct. Instead, economic analysis on a case-by-case basis is necessary to determine whether particular conduct is anticompetitive and the degree to which such conduct affected the relevant market.

> The AMEAs will adjust the initial proportion within the statutory scope in accordance with the degree of infringement of the monopoly conduct and determine the final proportion of fines thereof. In case of a serious infringement, the re-adjusted proportion of fines shall be no less than 6%; in case of a de minimis infringement, the re-adjusted proportion shall be no more than 3%.
>
> The degree of damage that the monopoly conduct causes to the market competition and consumer welfare will be taken into account in assessing the gravity of infringement. The AMEAs will assess the gravity of the infringement on a case-by-case base. The factors for the assessment mainly include the

geographic market area of the infringement, the degree of the implementation of the infringement, the price variation of relevant products and the damages incurred by consumers and other undertakings, etc.

CONCLUSION

We appreciate the opportunity to comment and would be happy to respond to any questions the NDRC may have regarding this comment.

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[1] The Global Antitrust Institute (GAI) at George Mason University is a leading international platform for research and education that focuses on the legal and economic analysis of key antitrust issues confronting competition agencies and courts around the world. University Professor Joshua D. Wright, Ph.D. (economics), is the Executive Director of the GAI and a former U.S. Federal Trade Commissioner. Koren W. Wong-Ervin is the Director of the GAI and former Counsel for Intellectual Property and International Antitrust at the U.S. Federal Trade Commission. Professor of Law Douglas H. Ginsburg is a Senior Judge, United States Court of Appeals for the District of Columbia Circuit, Chairman of the GAI's International Board of Advisors, and a former Assistant Attorney General in charge of the Antitrust Division of the U.S. Department of Justice. Associate Dean for Research and Faculty Development and Professor of Law Bruce H. Kobayashi, Ph.D. (economics), is a GAI Senior Scholar and Founding Director.

[2] Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); *see also* William M. Landes, *Optimal Sanctions for Antitrust Violations*, 50 U. CHI. L. REV. 652 (1983); Douglas H. Ginsburg & Joshua D. Wright, *Antitrust Sanctions*, 6 COMPETITION POL'Y INT'L 3, 3 (2010); Bruce H. Kobayashi, *Antitrust, Agency, and Amnesty: An Economic Analysis of the Antitrust Laws Against Corporations*, 69 GEO. WASH. L. REV. 715 (2001).

[3] Ginsburg & Wright, *supra* note 2.

[4] *See* Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 15 (1984) [hereinafter Easterbrook]; *see also* James C. Cooper et al., *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639, 658 (2005) [hereinafter Cooper et al.]; Joshua D. Wright, *Abandoning Antitrust's Chicago Obsession: The Case for Evidence-Based Antitrust*, 78 ANTITRUST L.J 241 (2012).

[5] *See, e.g.,* C. Frederick Beckner, III & Steven C. Salop, *Decision Theory and Antitrust Rules*, 67 ANTITRUST L.J. 41 (1999); James C. Cooper et al., *supra* note 4; David S. Evans & A. Jorge Padilla, *Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach,* 72 U. CHI L. REV. 73, 98 (2005); Keith N. Hylton & Michael Salinger, *Tying Law and Policy: A Decision-Theoretic Approach*, 69 ANTITRUST L.J. 469 (2001); Geoffrey A. Manne & Joshua D. Wright, *Innovation and the Limits of Antitrust*, 6 J. COMPETITION L. & ECON. 153 (2010).

[6] Pac. Bell Tel. Co. v. LinkLine Commc'ns, Inc., 555 U.S. 438, 451 (2009) ("To avoid chilling aggressive price competition, we have carefully limited the circumstances under which plaintiffs can state a

Sherman Act claim by alleging that prices are too low."); Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264, 283 (2007) ("[W]here the threat of antitrust lawsuits, through error and disincentive, could seriously alter underwriter conduct in undesirable ways, to allow an antitrust lawsuit would threaten serious harm to the efficient functioning of the securities markets."); Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 414 (2004) ("Mistaken inferences and the resulting false condemnations are especially costly, because they chill the very conduct the antitrust laws are designed to protect." (internal quotations omitted)).

[7] Easterbrook, *supra* note 4, at 15.

[8] *See, e.g.*, James C. Cooper et al., *supra* note 4; Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, *in* HANDBOOK OF ANTITRUST ECONOMICS 391, 409 (Paolo Buccirossi ed., 2008) [hereinafter Lafontaine & Slade]; Daniel O'Brien, *The Antitrust Treatment of Vertical Restraint: Beyond the Possibility Theorems*, *in* THE PROS AND CONS OF VERTICAL RESTRAINTS 40, 76 (2008) [hereinafter O'Brien].

[9] *See, e.g.*, Bruce H. Kobayashi & Joshua D. Wright, *The Limits of Antitrust and Patent Holdup: A Reply to Cary et al.*, 78 ANTITRUST L.J 2, 505, 704-07 (2012).

[10] "The objective of competition policy is to promote consumer welfare and economic efficiency, rather than to promote individual competitors or industries, and . . . enforcement of its competition law should be fair, objective, transparent, and non- discriminatory." Press Release, U.S. Dep't of Treasury, Sixth Meeting of the U.S.-China Strategic and Economic Dialogue U.S. Fact Sheet—Economic Track (July 11, 2014), https://www.treasury.gov/presscenter/press-releases/Pages/jl2563.aspx.

[11] *Trinko*, 540 U.S. at 407-08.

[12] James C. Cooper et al., *supra* note 4, at 658.

[13] Lafontaine & Slade, *supra* note 8, at 409.

[14] O'Brien, *supra* note 8, at 76.