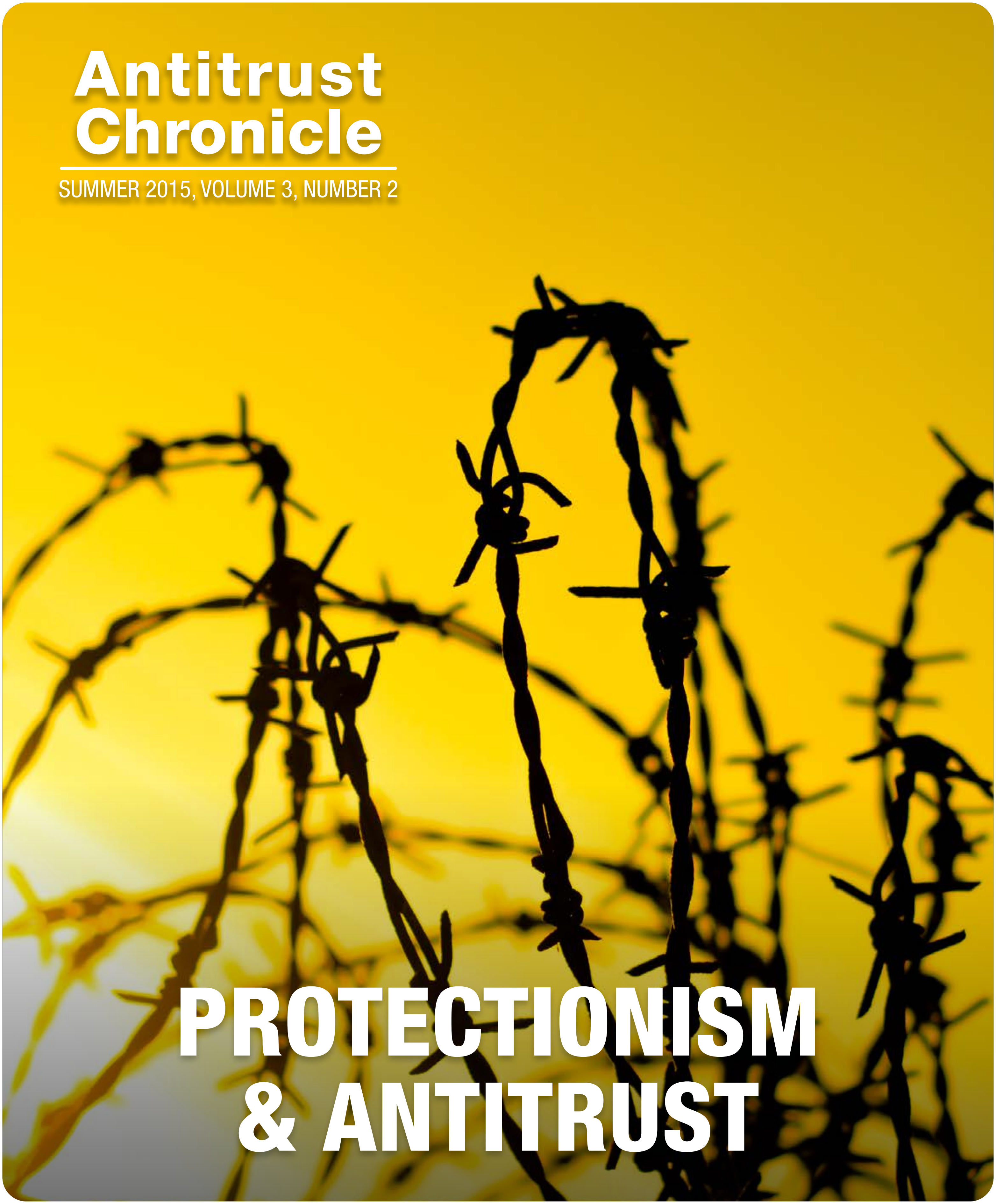

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The Public Interest and Competition-Based Scrutiny of Mergers: Lessons from the Evolution of Merger Control in the United Kingdom

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The Public Interest and Competition-Based Scrutiny of Mergers: Lessons from the Evolution of Merger Control in the United Kingdom

Alex Chisholm & Nelson Jung[1]

I. INTRODUCTION

Developments over the past few months have been described as a "volcanic rise in protectionist sentiments from national governments."[2] General Electric's bid for Alstom as well as numerous recent takeover proposals in the pharmaceutical sector, in particular Pfizer's attempt to acquire AstraZeneca and AbbVie's proposed takeover of Shire,[3] have reinvigorated the long-running debate about greater state intervention in cross-border deal-making. There have been calls for a widening of public interest tests in merger control, or for the use of other legislative tools designed to protect vital sectors of the economy from certain foreign takeovers.[4]

It has been said that a new wave of "economic patriotism" and protectionist tendencies is sweeping across many EU Member States. For example, in a display of re-invigorated *dirigisme*, the then French Economy Minister Arnaud Montebourg described his Government's intervention in the General Electric/Alstom deal as a "political success for the return in force of the state in the economy."[5] He went even further by proclaiming that the EU competition rules should change "because we need to make champions."[6] The French Government has reacted similarly strongly not just to foreign takeovers in infrastructure sectors, but also in relation to the mooted takeover of Danone by PepsiCo.[7] While questions are being raised as to whether France may be "losing badly needed foreign investment as a result of such policies,"[8] France is not alone.

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[2] Harry Philips, *The European Champions League,* 17(8) GLOBAL COMPETITION REV., 5 (2014).

[3] *AbbVie CEO Tells Employees That Shire Deal is Going Through,* W.S.J. (September 30, 2014).

[4] The proposed changes to the Takeover Code include a framework to regulate statements made by the parties to an offer relating to any course of action they commit or intend to take/not take, after the end of the offer period. *See* Consultation Paper issued by the Code Committee of the Panel, *Post-Offer Undertakings and Intention Statements*, The Takeover Panel, PCP 2014/2 (15 September 2014) (http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PCP201402.pdf).

[5] *See*, *GE deal "victory" for role of French state in economy'*, FINANCIAL TIMES (June 23, 2014).

[6] *France Feeds New European Economic Nationalism,* WSJ (June 27, 2014).

[7] *See*, *Danone: Not for Sale,* FORBES, (July 25, 2005) and *French fear eye of 'ogre' is on Danone,* N.Y. TIMES (July 21, 2005).

[8] *See*, *Blocking foreign takeovers – France fights back*, ECONOMIST (May 15, 2014).

Slow economic growth or stagnation and continuously high unemployment in many countries in the aftermath of the financial crisis provide what might at first sight appear to be a compelling justification to resort to interventionist industrial policies based on the belief that governments can "pick winners" by creating or protecting national champions.[9]

There also seems to be a wider perception that in the post-crisis climate European companies could be attractive targets for foreign investors, in particular in circumstances where U.S. companies appear to be driven by strong tax incentives to invest overseas. Apparently motivated by the desire to create stronger either national or European champions, the German chancellor Angela Merkel pronounced that consolidation in the mobile telecoms sector was necessary "so that we can score internationally."[10]

Even in the United Kingdom—traditionally a strong advocate in Europe of a competition-based regime, which only last year adopted the Enterprise and Regulatory Reform Act 2013 with a strong competition focus for its new Competition and Markets Authority ("CMA")—the debate in politics and the media about whether national interests need to be protected against foreign takeovers in special circumstances has been reinvigorated. This debate may now be gaining further momentum.[11]

At a global level, the recent breakdown of WTO talks has been interpreted as a further sign of protectionist tendencies prevailing over the liberal vision of a multilateral trading system that has guided the post-war era in the global economy since Bretton Woods.[12] There is also a growing concern that these developments may have a chilling effect on cross-border transactions that may be pro-competitive or welfare-enhancing.

Meanwhile, the European Commission ("EC") displays no signs of softening its resolve to defend the Internal Market freedoms and its exclusive jurisdiction to assess mergers with a Community dimension based on competition rather than industrial policy criteria. Outgoing EU Competition Commissioner Joaquín Almunia recently voiced concerns about a rising tide of protectionism in Europe, citing public debate over the handling of General Electric's bid for Alstom's energy business as only one example of "protectionist signals" in Europe.[13] Recent statements by his likely successor, Margrethe Vestager, suggest continuity in approach. She noted, "in the long run, and also in the short run, it is for everyone's best [interest] that we have a strong competition culture and that we keep protectionism at bay."[14] Vestager rejected the notion that competition rules should be relaxed to accommodate European Champions and stated, "We

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[9] Protectionist tendencies in EU Member States were also observed in the mid-noughties, *see* for instance Nourry & Jung, *EU State Measures against Foreign Takeovers: "Economic Patriotism" in All But Name,* 2(2) COMPETITION POL'Y INT'L. (2006).

[10] *Merkel backs EU telco consolidation,* FINANCIAL TIMES (May 8, 2014).

[11] *See*, for instance, Mark Field MP, *After Astra-Zeneca/Pfizer – Is Protectionism Part of the 'New Economics'?* (August 4, 2014).

[12] *See*, for instance: *WTO plunged into crisis as doubts grow over its future,* FINANCIAL TIMES (August 1, 2014).

[13] *Almunia voices concerns over rising protectionism*, MLEX (June 24, 2014).

[14] She also stated that competition can be an enabler for more jobs and prosperity in Europe, *see, Vestager vows to resist protectionism, antitrust politicization*, MLEX (September 29, 2014).

can compete better in big markets if companies have competed and succeeded in smaller markets as well."[15]

This article commences by briefly summarizing the evolution of merger control regimes, away from broad public interest tests and towards a competition-based assessment, in the United Kingdom and also internationally. In light of the recent, increasingly vocal demand for new or wider public interest considerations, it is time to take stock and explore what implications a shift or reversal in policy of this type may have. In order to do so, we set out to answer the question whether the U.K. merger control regime is in good health. One of the key tenets of medicine is the injunction that doctors should "first, do no harm;" any treatment required for a merger control regime must thus be based on a thorough diagnosis of its current state and the full potential implications of the medicine to be prescribed.

We will therefore examine the legal framework governing the current U.K. merger control regime insofar as public interest considerations are concerned, including its important interface with EU law. We then briefly move outside the confines of merger control to assess the extent to which public interest considerations can be invoked under foreign investment control rules in the United Kingdom and a number of other jurisdictions. Against this background, the article examines evidence relating to the economic impact of foreign investment, before it points to costs and risks that may arise if the United Kingdom or other jurisdictions were to broaden public interest tests in merger control. In the final section we will identify some hallmarks of what we regard as an economically efficient and durable regime.

We are not legislative policy makers. Instead, the CMA, as a statutory body and operator of the U.K. merger control machinery, applies the law as it is enacted. We are, however, mindful of the ongoing need to keep under review the working of the regime and how it is applied in light of new circumstances and observed shortcomings. It would be remiss not to point out costs and risks of potentially forfeiting the valuable progress made in recent years in clarifying and strengthening competition law regimes across the world—and with it the world trading system—and thereby greatly improving consumer welfare outcomes and easing tensions between nations. Any reversal of this progress would not be costless, in particular if examined in an international context.

II. THE EVOLUTION OF PUBLIC INTEREST TESTS IN U.K. MERGER CONTROL—TOWARDS GREATER PREDICTABILITY

Historically, prior to the entry into force of the Enterprise Act 2002 (the Enterprise Act), U.K. mergers were reviewed on a broad public interest test under the Fair Trading Act 1973.[16] Under this regime, the concept of public interest was carried over from the Monopolies and Restrictive Practices (Inquiry and Control) Act 1948. Guidance on the interpretation of public

[15] *Relaxed rules for EU 'champions' carry cost, Vestager says,* MLEX (October 2, 2014).

[16] Under s84 of the Fair Trading Act 1973, the Competition Commission, and its predecessor, the Monopolies & Mergers Commission, were required to take into account "all matters which appear to them in the particular circumstances to be relevant" with regard to the desirability of certain factors.

interest in that legislation has been described as being "expressed at such level of generality as to amount to an invitation to take into account anything that might seem relevant."[17]

The impact on competition as a key factor in the assessment of mergers was given more prominence in 1984 when the then Secretary of State, Norman Tebbit, announced that "references to the Monopolies and Mergers Commission (MMC) would be made primarily, but not exclusively, on competition grounds, taking into account the international dimension of competition."[18]

This "Tebbit doctrine" was given policy support in a Department of Trade and Industry ("DTI") paper that set out a strong case for a largely depoliticized merger control regime.[19] The issues considered by the DTI in 1988 bear a remarkable resemblance to those at the forefront of current debate. In its review, the DTI dealt with submissions arguing for a wide range of issues other than competition to justify intervention, including effects on employment, regional economic development, research on development spending by companies, the consequences of highly leveraged bids, and foreign takeovers.

In response to these submissions, the DTI posited that none of these matters is one where the public interest typically diverges from the interests of private sector decision makers, although it recognized that it may do so in exceptional cases. The DTI found that "normally, therefore, the decision should be left to the market" and went on to state that, "The Government sees no case for intervening on a regular basis to prevent private firms from carrying through their business decisions on the ground that those plans may have adverse immediate implications for such matters as employment or R&D."[20]

In shifting towards a competition-based assessment, successive British governments had taken on board years of concerns raised in connection with the lack of transparency and predictability of the public interest test, which risked deterring mergers that were beneficial to the economy. [21]

Despite the incremental move towards free market policies and the promotion of competition as the main feature of merger control, a considerable degree of political involvement remained part of the assessment process, manifesting itself most notably in the "Lilley doctrine:" In 1990 the then Secretary of State for Trade Peter Lilley announced a new approach to assessing

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[17] A. Scott, M. Hvvid, & B. Lyons, *Merger Control in the United Kingdom*, OUP 2006, page 5.

[18] First report: Takeovers and mergers, 27 November 1991 HC 1991-2 ¶ 223.

[19] DTI, *Mergers policy: a Department of Trade and Industry paper on the policy and procedures of merger control* (HMSO, 1988).

[20] DTI, *Mergers policy: a Department of Trade and Industry paper on the policy and procedures of merger control* (HMSO, 1988).

[21] *See* Andreas Stephan, *Did Lloyds/HBOS mark the failure of an enduring economics based system of merger regulation?,* NORTHERN IRELAND LEGAL Q., 4 (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1931007.

mergers designed to resist "nationalisation by the back door"[22] through the takeover of British companies by state-owned foreign companies.

One of the problematic aspects of the Lilley doctrine was that the Monopolies and Mergers Commission ("MMC", the forerunner of the Competition Commission) could not lawfully act on any presumption that acquisition by a state-controlled company (whether foreign or not) was contrary to the public interest.[23] However, the policy turned out to be short-lived:[24] In the few references Lilley made under his new policy no adverse effects were found on that basis and clearances were recommended. The Lilley doctrine was therefore considered unsustainable especially in the context of a general move towards an independent competition regulator.[25]

Even though only a small proportion of mergers were referred to the MMC on non-competition grounds, it remained difficult for firms to predict with certainty when a merger would be blocked.[26] In its 1991 report on takeover, the Trade and Industry Committee considered the impact of the Lilley doctrine and noted that "following a complaint to the European Commission that this policy discriminated against foreign companies, the Commission asked the Government to explain and justify its policy." The U.K. Government agreed with the Commission in October 1991 that, "the fact that a company is state-owned or directed by a state will not per se justify a referral to the MMC; unless, exceptionally, other public interest issues (such as security interests) arise, a referral would only be envisaged insofar as competition aspects were at stake."[27]

About ten years on, in 2002, the primacy of a competition-based test was codified in the Enterprise Act, which has been described as having put an end to "substantial room for the exercise of political preferences."[28] It is interesting to observe that, having experienced decades of merger control policies relying on a vague concept of public interest, and having drawn lessons from the Tebbit and Lilley doctrines, there was broad political consensus across all parties represented in Parliament to move towards a competition-based test when the Enterprise Act was adopted.[29] That said, the existence of such a consensus behind the principle that a

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[22] HC Deb 26 July 1990 cc 415-6W. The statement was reproduced in Department for Trade and Industry press notice 90/457, Merger reference policy, 26 July 1990. *See* also Antony Seely, *Takeovers: the public interest*, House of Commons Library, 7 (June 3, 2014).

[23] *Id*.

[24] *See* McElwee, *Politics and the UK merger control process: the public interest exceptions and other collision point*, COMPETITION L., 80 (2010), and Seely, *Id*. at 7-8.

[25] *First report: Takeovers and mergers*, 27 November 1991 HC 90 1991-92 and summary in House of Commons and Seely, *Id*..

[26] *See* Stephan, *supra* note 20.

[27] *See* Seely, *supra* note 21 at 9

[28] S. Wilks, *In the Public Interest: Competition Policy and the Monopolies and Mergers Commission*, MUP, 228 (1999).

[29] The Enterprise Bill, as proposed by the Labour government to make the merger regime "more competition-focused," was generally welcomed. *See* for example, speaking for the Conservatives, John Whittingdale who said "There are several specific measures in the [Enterprise] Bill to which we are happy to give unqualified support. The first is the decision to remove Ministers from the decision-making process on the clearance of mergers." And for the Liberal Democrats, Dr. Vince Cable (now Secretary of State) noted at the time that "it is right that we should move away from the vague public interest test to a competition test." HC Deb 10 April 2002 c54-55 and c66. Vince Cable

competition test is the right one has not protected politicians from pressure to intervene in specific cases where particular interests are threatened.

The use of an economics-based competition assessment of mergers brought the United Kingdom in line with international evolution of merger control policy.[30] The trend towards narrower, economics-based criteria, a more technical assessment, and fuller reported analysis was observed across many jurisdictions. This development coincided with competition authorities responsible for merger control becoming more independent and the process as a whole becoming more transparent and predictable for businesses.

The accumulated learnings from the experience of different national regimes in handling merger cases, coupled with the desire of individual countries to make their markets attractive locations for business activity, can be seen as key drivers for these important trends.

III. MERGER CONTROL AND THE PUBLIC INTEREST—THE EXISTING LEGAL FRAMEWORK AND KEY PRECEDENTS

A. The Framework for Assessing Mergers Within the U.K.'s Jurisdiction

Today, merger control in the United Kingdom is performed primarily by the CMA[31] under the Enterprise Act 2002.[32] Where the relevant jurisdictional thresholds are met, and the transaction is not subject to the EU Merger Regulation, the CMA has the power to investigate mergers and acquisitions irrespective of the (corporate) nationality of the acquirer.[33] In examining mergers, the CMA conducts an economics-based competition assessment. The question before it is whether the merger has resulted, or may be expected to result, in a substantial lessening of competition ("SLC") within any market or markets in the United Kingdom for goods or services.[34]

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also suggested that the Enterprise Act would result in a higher proportion of mergers, in particular large mergers, being referred for examination. *See* Seely, *supra* note 21.

[30] The United States, for example, has long since relied on an economics-based competition assessment (*see* the Clayton Act 1914, as subsequently amended, among others, such as the 1992 Horizontal Merger Guidelines) and the EU had adopted its Merger Regulation in September 1989: Council regulation (EEC) No 4064/89 on the control of concentrations between undertakings, OJ [1989] L 395/1. Note that the EU's test at the time was the "creation or strengthening of a dominant position," which has since been amended to a "significant impediment to competition" test.

[31] The CMA is responsible for merger control across all industries and has decision-making power, although certain sectoral regulators such as Ofcom or Monitor also have statutory roles in examining mergers. The CMA was established on October 1, 2013. By virtue of the Enterprise and Regulatory Reform Act 2013 and the Enterprise and Regulatory Reform Act 2013 (Commencement No 6, Transitional Provisions and Savings) Order, No 416 of 2014, the OFT and CC's merger control functions were transferred to the CMA on April 1, 2014.

[32] As amended by the Enterprise and Regulatory Reform Act 2013.

[33] There is no separate body or process in the United Kingdom for the control of foreign investment. The CMA's primary duty is to seek to promote competition, both within and outside the United Kingdom, for the benefit of consumers, *see CMA Mergers: Guidance on the CMA's jurisdiction and procedure*, ¶ 2.5 (Jan. 2014).

[34] The decision at first phase is based on a "realistic prospect" threshold in determining whether it is or may be the case that a SLC will arise from the merger whereas the second phase decision is made on a "balance of probabilities" threshold.

B. The Role of the Secretary of State—Public Interest Grounds

Provision is made under the Enterprise Act allowing for intervention in mergers by the Secretary of State on certain specified public interest grounds.[35] The Secretary of State may, for instance, issue an "intervention notice" to the CMA if he or she considers one or more public interest considerations to be present in a particular merger.[36] Currently, in public interest cases, these considerations are specified in the Enterprise Act[37] as being (i) national security, (ii) media plurality, and (iii) the stability of the U.K. financial system. The majority of intervention notices in public interest cases have been issued in respect of national security considerations.[38]

The Enterprise Act recognizes the possibility that, exceptionally, these grounds for intervention could be supplemented. Any proposal to do so, however, is governed by a procedure ensuring careful scrutiny. The Secretary of State can only add a public interest consideration by way of adopting a statutory instrument if it is approved by Parliament through an affirmative procedure. [39]

C. Observations on the Operation of Public Interest Considerations in Practice

On several occasions there have been calls for an expansion of the list of public interest considerations or a greater reliance on such considerations to intervene.[40] However, in practice,

[35] The Secretary of State may intervene where he or she considers that one or more so-called "specified considerations" is relevant to the merger in question. Under the Enterprise Act 2002, these specified considerations may apply to three types of mergers, namely public interest mergers, special public interest mergers, and European relevant merger situations. *See* J. Parker & A. Majumdar, *UK merger control*, 143 et seq. (2011).

[36] *See* section 42 of the Enterprise Act. In terms of process, the CMA must then make a report to the Secretary of State advising whether a relevant merger situation has been or will be created and whether that has resulted or may be expected to result in a substantial lessening of competition. The CMA's report also contains a summary of any representations received by the CMA relating to any public interest consideration mentioned in the intervention notice. It is then for the Secretary of State to take a decision on whether to refer the merger for a second-phase review. He may refer such cases where he believes that the merger operates or may be expected to operate against the public interest, taking account of a substantial lessening of competition identified by the CMA and the existence of one or more specified public interest considerations. Under the Enterprise Act, an anticompetitive outcome is to be treated as being adverse to the public interest unless it is justified by one or more public interest considerations. After receiving the Phase 2 report from the CMA, the Secretary of State makes a final decision as to whether the merger operates against the public interest and may take such enforcement action that he or she considers reasonable and practicable to remedy, mitigate, or prevent any of the adverse effects identified. This may extend to prohibiting the merger.

[37] *See* section 58 of the Enterprise Act.

[38] National security cases include Alvis Plc/General Dynamics Corporation, Finmeccanica/AgustaWestland 2004, Finmeccania/ BAE Systems 2005, Lockheed Martin UK Holdings Limited/Insys Group Limited 2005, General Electric/Smiths Aerospace Division 2007, and Atlas Elektronik/QinetiQ 2009. *See* further cases where intervention notices have been issued in respect of other considerations (media plurality and stability of U.K. financial system): BSkyB/ITV 2007, Global/GMG Radio 2012, Newscorp/BskyB 2010, Lloyds/HBOS 2008,

[39] Section 58 Enterprise Act 2002. *See* also http://webarchive.nationalarchives.gov.uk/20101227023510/http://www.bis.gov.uk/policies/business-law/competition-matters/mergers/mergers-with-a-public-interest.

[40] When a possible acquisition of Centrica by Gazprom was rumored in 2006, for instance, Tony Blair ruled out any possibility that U.K. ministers might actively seek to block a future bid by Russia's Gazprom for Centrica, the gas supplier. Mr. Blair reportedly considered that any Gazprom bid for Centrica could be dealt with satisfactorily by the

the only additional public interest consideration added since 2002 is the stability of the U.K. financial system, during the financial crisis and in the context of the Lloyds/HBOS merger. [41]In that case, the then Secretary of State issued an intervention notice based on a public interest consideration that had not yet been included in the Enterprise Act. On the same day the order introducing the new public interest consideration came into force,[42] the Office of Fair Trading ("OFT") issued its report on the transaction concluding that it may be expected to result in an SLC, meaning that the competition-based test for reference was met. However, the Secretary of State considered that the new public interest consideration—the stability of the U.K. financial system—overrode the concerns identified by the OFT and decided that the merger should not be referred for further investigation.[43]

Some expert commentators have since argued that the merger seriously damaged competition and suggested that HBOS should have perhaps instead been nationalized.[44] Even some of those skeptical about removing elected politicians from the process of merger control[45] noted that this case, and others such as BSkyB/ITV[46] and News International/BskyB,[47] "have been marked by disagreements amongst the authorities concerned, significant behind the scenes lobbying, a very drawn out process as regards the media mergers and, ultimately, controversial final decisions."[48] The experience, therefore, has been characterized as "a cautionary tale" for

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U.K.'s independent competition authorities. A newspaper quoted him as noting that Britain should face down the wave of "economic patriotism" shown by some EU states, *see, Blair rules out blocking Gazprom Centrica bid,* FINANCIAL TIMES (April 25, 2006).

[41] Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008 (SI 2008/2645).

[42] October 24, 2008.

[43] *Supra* notes 33-34.

[44] Sir John Vickers, former Chief of the OFT and later chairman of the Independent Commission on Banking noted in 2010 that it was a mistake to force the merger through on public interest grounds. *See*, *Sir John Vickers calls Lloyds takeover of HBOS a mistake*, GUARDIAN, (November 26, 2010).

[45] Graham, *Public interest mergers,* 4 (March 2013, to be published).

[46] In November 2008 BSkyB acquired a 17.9 percent stake in ITV. Both companies were active in television production and broadcasting. The Secretary of State issued a public interest intervention notice requesting the OFT and Ofcom examine whether the merger gave rise to competition and media plurality concerns. The OFT and Ofcom found the merger gave rise to concerns on both counts, and the merger was referred to the CC. The CC's report concluded that the merger did result in a substantial lessening of competition, but did not operate against the public interest of media plurality. The CC recommended undertakings to reduce the shareholding in ITV down to 7.5 percent. BSkyB appealed unsuccessfully to the CAT and then the Court of Appeal, and finally entered into the undertakings in 2010.

[47] In November 2010, Newscorp notified the European Commission of its intention to acquire the remaining 61 percent shareholding in BSkyB. Given that both companies were active in media in the United Kingdom, and Newscorp already owned 39 percent of BSkyB, the Secretary of State issued a European Intervention Notice citing media plurality concerns. The competition review remained with the Commission, and Ofcom was tasked with investigating the public interest concerns. The Commission cleared the merger on competition grounds but Ofcom found that it may operate against the public interest and recommended the Secretary of State refer it to the CC. Newscorp and the Secretary of State entered into discussions over undertakings in lieu, and two public consultations on the same were launched. Before the final consultation finished, news of the "phone hacking" scandal broke, embroiling Newscorp in controversy and leading it to close the News of the World newspaper. Shortly after, Newscorp withdrew its undertakings, and the Secretary of State referred the transaction to the CC. Two days later Newscorp announced it had abandoned the transaction.

[48] Graham, *supra* note 43.

those who see a bigger role for non-competition considerations within competition law and has been seen as encouraging lobbying by those who want to support particular interests.[49]

D. System "In Operation, Not Disarray"

It has also been argued, however, the Lloyds/HBOS case demonstrated that even such exceptional events did not require a disapplication of the U.K. merger control regime altogether, but could be dealt with on the basis of the existing legal structure under the Enterprise Act, which allows for narrowly defined public interest exceptions.[50] The then Chairman of the Competition Commission noted, "UK merger control procedures were in practice flexible enough to deal with a highly sensitive case of this kind. In providing a statutory mechanism for balancing competition against financial stability, albeit at ministerial level, and an opportunity for judicial review, the UK showed up better than those jurisdictions that simply disapplied merger control altogether from bank mergers as an emergency measure."[51]

Cases where public interest considerations have been invoked, including BSkyB/ITV, have also shown that the current system does provide for appropriate mechanisms allowing for good outcomes for consumers even if there are differences in opinion of the authorities involved.[52]

In summary, therefore, it seems fair to observe that the U.K.'s regime governing public interest considerations has been tried and tested for more than a decade and, despite the "cautionary tale" in Lloyds/HBOS, has proven capable of being able to deal even with extraordinary circumstances, such as in a global financial crisis. It has rightly been held to be "in operation, not disarray."[53]

E. The Interface Between U.K. and EU Law

From the perspective of the United Kingdom or any other EU Member State, the scope for intervention based on public interest considerations is subject to EU law requirements. If the transaction in question meets the relevant turnover thresholds, and is not referred back for examination at Member State level, it will be considered under the EU Merger Regulation ("EUMR") by the European Commission ("EC").[54] In such circumstances, the transaction falls within the EC's exclusive jurisdiction under Article 21 EUMR. Regardless of whether or not a

[49] Graham, *supra* note 43.

[50] *See* also Martin McElwee, who contrasts the approach taken in Lloyds/HBOS with a statutory provision relating to the Bradford & Bingley case which, in effect, disapplied the U.K. merger control regime in its entirety, *Politics and the UK merger control process: the public interest exceptions and other collision points,* COMPETITION L., 82 (2010).

[51] Peter Freeman, *We are in a very melancholy situation: financial crisis and competition policy,* speech to David Hume Institute, (November 3, 2009).

[52] *See* notes 44 and 45, *supra*.

[53] Peter Freeman, *Merging is Such Sweet Sorrow*, Speech to the British Institute of International and Comparative Law (BIICL) Mergers Conference, (November 13, 2008).

[54] Under either Articles 4(5) or 9 of the EUMR.

transaction falls to be considered under the EUMR, measures preventing cross-border transactions in the European Union may be caught by the free movement rules.[55]

Prior to the first EUMR[56] entering into force in September 1990, Sir Leon Brittan commented that:

> the future of the major players in European business who are involved in mergers is now in [the Commission's] hands…They will benefit from a one stop shop, where there is one analysis by one authority on the basis of competition criteria which takes one month and is binding throughout the European Community. If there are serious doubts about a concentration compatibility with the Common Market, a further analysis becomes necessary…And, once again, subject to only two exceptions, the Commission's decision is final throughout the Community and is reviewable only by the Community's courts.[57]

In terms of the substantive assessment carried out by the EC, similar to the U.K.'s SLC test, the EC's significant impediment of effective competition ("SIEC") test under the EUMR is based on an economic assessment and allows for consideration of consumer benefits and efficiencies, but not considerations of industrial policy such as the protection of jobs. However, Article 21(4) EUMR specifically recognizes public security, plurality of the media, and prudential rules as legitimate public interests justifying intervention.[58] These three public interest exceptions enshrined in the EUMR reflect a delicate and hard-earned compromise that was 17 years in the making and the Commission has been strict and narrow in its interpretation.[59]

F. Member States Intervening on the Basis of Existing Exceptions

In the United Kingdom, if the Secretary of State is considering taking measures to protect certain legitimate interests outside of the scope of the EC's merger control review, he may issue a

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[55] In particular Article 63 (free movement of capital) and Article 49 (freedom of establishment) of the Treaty on the Functioning of the European Union.

[56] At that time it was Council Regulation 4064/89, referred to as the ECMR.

[57] SIR LEON BRITTAN, HERSCH LAUTERPACHT MEMORIAL LECTURES: COMPETITION POLICY AND MERGER CONTROL IN THE SINGLE EUROPEAN MARKET, 35, 38 (1991). Also *see* C. Bright, *The European Merger Control Regulation: Do Member States Still Have An Independent Role In Merger Control*? *Part 1*, 12 ECLR (1991) and J Galloway, *EC merger control: does the re-emergence of protectionism signal the death of the 'one stop shop?* University of East Anglia, Paper to the 3rd Annual CCP Summer Conference (June 2007).

[58] *See* discussion of cases involving the interpretation of these provisions in M. FURSE, THE LAW OF MERGER CONTROL IN THE EC AND THE UK, 58-61(2007) and C.M. Borges, *The Legitimate Interests of Member States in EC Merger Law*, 9 EUR. PUBLIC L. 345 (2003).

[59] There have been only a few cases in which Member States have intervened in transactions under Article 21(4) EUMR. Although Member States are not required to seek formal approval, there have been cases where the Commission has specifically stated that Article 21(4) applies. *See* for example: M.423 Newspaper Publishing, M.759 Sun Alliance/Royal Insurance, M.1858 Thomson/Racal (II). Any intervention on these grounds must be no more than is necessary and proportionate to achieve these goals. It is also worth noting that any intervention must be specifically justified on these grounds: thus, for example, an intervention cannot be made on one ground for a collateral reason, e.g. to preserve a media outlet because of the employment opportunities it offers.

European Intervention Notice.[60] The CMA then has the authority to review the merger and provide a report to the Secretary of State.[61]

Article 21(4) states that Member States are entitled to "take appropriate measures to protect legitimate interests other than those taken into consideration by [the EUMR] and compatible with the general principles and other provisions of Community law."[62] If the "legitimate interest" a Member State seeks to rely upon falls within the narrowly defined categories described above, no formal approval is required although the EC continues to assess the impact of the transaction on competition.

G. Member States Intervening on the Basis of New Exceptions

However, for any public interest considerations outside these narrowly construed three exceptions, authorization must be requested from the EC before taking any measures. Hence, when Member States wish to intervene in a transaction with a Community dimension, they should be prepared to either: a) argue that action is necessary, proportionate, and consistent with EC law in order to protect public security, plurality of the media, or prudential rules; or b) communicate the "public interest" rationale for action to the EC and request authorization to take action. The EC will then assess whether the proposal is "appropriate, proportional and non-discriminatory"[63] before reaching a decision.[64]

The EC will consider the wider effects of consenting to the proposal, which also involves an examination of the compatibility of the proposed measures with the free movement rules under the TFEU, including a proportionality assessment.[65] Given its role as guardian of the TFEU and its internal market, one can generally expect the EC to ensure that unduly interventionist national industrial policies do not override competition policy objectives and that it will be mindful of the "Pandora's Box effect" and the risk of copy-cat style industrial protection. Indeed, it is very rare for the Commission to approve interventions by Member States outside of the recognized legitimate interests.[66]

If the EC approves of a public interest intervention on specific grounds put forward by a Member State, it would appear that such intervention grounds should then in principle be

[60] Under section 67 of the Enterprise Act.

[61] The report will cover both the usual competition considerations as well as including advice and recommendations on any public interest considerations (*see* The Enterprise Act 2002 (Protection of Legitimate Interests) Order 2003). The Secretary of State may then make a decision on whether to refer the merger for a second phase investigation. The decision must be taken on the basis of the relevant public interest consideration only. The CMA must then report on whether a relevant merger situation has been created (that meets the EUMR thresholds) and whether that merger operates or may operate against the public interest (having regard only to the legitimate interests specified).

[62] Although Member States may intervene to prohibit a merger that is cleared by the Commission (on competition grounds), Member States are not permitted to "clear" a merger to overrule a prohibition decision by the Commission.

[63] *See*, for instance, the EC's reasoning in Case M.567 Lyonnaise des Eaux SA/Northumbrian Water Group.

[64] J. Galloway, *EC merger control: does the re-emergence of protectionism signal the death of the 'one stop shop?* University of East Anglia, Paper to the 3rd Annual CCP Summer Conference (June 2007).

[65] The EC has 25 working days within which to inform the Member State of its assessment.

[66] As far as we are aware, this has only happened on one occasion (M.*567 Lyonnaise des Eaux SA/Northumbrian Water Group* following the UK Water Industry Act 1995).

available to all other Member States, although each proposed Member State measure seeking to rely on such grounds would likely be subject to the same considerations of wider effects, including a proportionality assessment. If, however, the EC does not approve the application of a new public interest consideration, the EC (and possibly interested third parties) could challenge any attempt by a Member State to intervene on such grounds in the EU courts.

H. The European Commission Protecting its Exclusive Jurisdiction and Free Movement Rules

The EC has pursued Member States for a breach of its exclusive jurisdiction under Article 21 EUMR on several occasions and such proceedings have generally been brought in parallel with proceedings for acting in breach of the EU's free movement rules.[67] The Commission generally commences this process by way of "preliminary conclusions" addressed to the Member State for comments within a short period of time.[68] Following that, the Commission may then go on to adopt a final decision ordering the withdrawal of the measure in question.

It did so for the first time in the *BSCH/Champalimaud* case.[69] Portugal opposed a bank merger that had been notified to the EC. The EC issued a decision requiring Portugal to suspend (and then withdraw) its opposition to the transaction contrary to Article 21 EUMR, ultimately allowing the deal to proceed. In *Secil/Holderbank/Cimpor*,[70] Portugal was again subject to infringement proceedings when it obstructed the acquisition of a cement company without communicating with the EC in accordance with Article 21(4) EUMR. The parties withdrew their notification to the EC. Nevertheless the EC issued a decision finding Portugal in breach of Article 21(4) and requiring it to withdraw the offending measures. The EC's decision was upheld by the Court of Justice, but the deal finally collapsed.[71]

In *Unicredito/HVB*,[72] the EC cleared Unicredito's acquisition of HVB. Poland required that, in addition, Unicredito should divest itself of shares in a Polish bank. The EC informed

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[67] In addition, there are at least two other cases where the EC opened an investigation but did not formally intervene, *see* BBVA/ABN AMRO/BNL/Banco Antonveneta (IP/05/1595) and Suez / Gaz de France. It should also be noted that the Commission does not need to have completed its merger control assessment and cleared the transaction in order to start an Article 21 infringement procedure. *See* further Damien Gerard, *Protectionist threats against cross-border mergers: unexplored avenues to strengthen the effectiveness of Article 21 ECMR,* COMMON MARKET L. REV. (June 2008).

[68] *Id*.

[69] Commission Press Release IP/99/533, 20 July 1999; Commission Press Release IP/99/551, 20 July 1999; Case M 1616, decision of 3 August 1999, OJ [1999] C 306/37; Commission Press Release IP/99/610, 3 August 1999; Commission Press Release IP/99/669, 9 September 1999; Commission Press Release IP/99/773, 20 October 1999; Commission Press Release IP/99/774, 20 October 1999; Commission Press Release IP/99/818, 3 November 1999; Commission Press Release IP/20/296, 27 March 2000.

[70] Case M 2054 of 20 November 2000, but the notification was withdrawn by the parties on January 11, 2001 before the Commission had reached a decision. *See* further Commission Press Release IP/00/1338, 22 November 2000 and Case C-42/01 Portuguese Republic v European Commission [2004] ECR I-6079.

[71] Portugal appealed the decision but the ECJ dismissed Portugal's appeal. *See* Portuguese Republic v. European Commission, Case C-42/01.

[72] Case M.3894, decision of 18 October 2005, OJ [2005] C 278/8, *see* further the Commission Press Release IP/05/1299, 18 October 2005; Case M.4125, see Commission Press Release IP/06/277, 8 March 2006.

Poland that its measures violated Article 21 EUMR as well as the free movement of capital and freedom of establishment. Ultimately the transaction was allowed subject to some divestments.[73]

In *Albertis/Autostrade*,[74] the EC cleared Albertis' acquisition of Autostrade. Italy objected on the basis that the Spanish acquirer would not be able to make the necessary investment in Italian motorways. The deal subsequently fell through, but the EC issued a decision finding Italy in breach of article 21 EUMR and the free movement rules. The parties appealed, but the General Court dismissed the parties' appeal on the basis that they had voluntarily put an end to the deal. Eventually, Italy withdrew the obstacles to the merger and the EC closed the infringement proceedings.

The *E.ON/Endesa*[75] case is perhaps the most famous example of the EC pursuing infringement proceedings for violation of Article 21 EUMR and the free movement rules. The EC examined E.ON's bid to acquire Spanish energy company Endesa under the EUMR.[76] In the meantime, Spain passed a royal decree giving the Spanish energy regulator ("CNE") powers to assess and impose conditions on transactions in the energy sector.[77] Shortly after the EC decided to clear the transaction unconditionally, the CNE imposed several conditions on the transaction.[78] In response, the EC issued a decision finding that Spain had breached article 21 EUMR and made a formal request that Spain should comply. Spain reacted by amending, but not fully withdrawing the conditions. After some further iterations between Spain and the EC, the EC initiated infringement proceedings against Spain before the EU Court of Justice in March 2007.[79]

The Court agreed that the actions by the Spanish government violated EU Law, noting that arguments put forward by the Spanish government regarding security of supply of energy were not sufficient justification. Ultimately, E.ON withdrew its bid in exchange for a promise from rival bidders (Enel and Acciona) to sell it some of Endesa's assets.[80] However, the Court's

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[73] In 2005, the EC approved the acquisition of HVB (a German bank that indirectly controlled a Polish bank) by Unicredit (an Italian bank). When the Polish Treasury ordered the sale of the shares on the basis of a non-compete clause, the EC pursued the Polish state for a breach of Article 21. Ultimately the transaction was allowed (subject to some divestments). Both the Polish appeal against the clearance and the EC's proceedings against Poland for breaching Article 21 were ultimately dropped.

[74] Case M.4249, decision of 22 September 2006, OJ [2006] C 268/7; Commission Press Release IP/06/1244, 22 September 2006; Commission Press Release IP/06/1418, 18 October 2006; Commission Press Release MEMO/06/414, 7 November 2006; Commission Press Release IP/06/1561, 14 November 2006; Commission Press Release IP/07/117, 31 January 2007; Case T-58/09 Schemaventotto v Commission [2010] E.C.R. II-3863.

[75] Case M.4110, decision of 25 April 2006, OJ [2006] C 114/6; Commission Press Release IP/06/528, 25 April 2006; Commission Press Release IP/06/1265, 26 September 2006; Commission Press Release IP/06/1853, 20 December 2006; Commission Press Release IP/28 March 2007; C-196/07 Commission v Kingdom of Spain [2008] ECR I-41; Commission Press Release MEMO/08/147, 6 March 2008.

[76] A rival bid had been made by Gas Natural.

[77] This royal decree was also challenged before the Court of Justice: Commission v Kingdom of Spain, Case C-207/07.

[78] CNE approved the bid but subject to nineteen conditions, including: (i) an obligation to maintain Endesa's headquarters in Spain, (ii) an obligation to keep Endesa duly capitalised and not to exceed a certain debt ratio, and (iii) an obligation to divest Endesa's non-mainland assets.

[79] Case C-196/07 Commission v Spain

[80] While the EC was pursuing infringement proceedings against E.ON, the transaction itself changed course as E.ON agreed with Enel (an Italian company) and Acciona (a Spanish company) that upon their acquisition of

judgement confirms the EC's position that Member States cannot create unwarranted obstacles to mergers that fall under the EC's exclusive jurisdiction under Article 21 EUMR. The Court also clarified that the fact that E.ON had abandoned the public offer after the expiry of the deadline for the withdrawal of the illegal conditions does not render the proceedings devoid of purpose.

I. Practical Implications of Far-Reaching Effects of EUMR and Free Movement Rules for Member States

The vigorous stance the EC has taken in these cases illustrates its determination to ensure that free movement rules and the EC's exclusive jurisdiction under the EUMR are not obstructed by Member States measures designed to prevent foreign takeovers.[81] There is no sign that the EC has moved away from its policy position that "the EU's single market will descend into chaos" if Member States stand in the way of mergers falling within its exclusive jurisdiction.[82]

EU Member States are therefore likely to face significant scrutiny and possibly strong opposition from the EC where they seek to invoke public interest considerations in mergers with a Community dimension, whether on the basis that such measures may be (i) in breach of the EU's free movement rules, (ii) in breach of the EC's exclusive jurisdiction under Article 21 EUMR, or (iii) in breach of both.

The EU's free movement rules may be engaged and possibly violated by exercising public interest exceptions even if the merger is not subject to the EUMR and falls within the scope of domestic merger control legislation. This may even be the case where the acquirer is not established in the European Union: The free movement of capital provision under the TFEU[83] not only prohibits restrictive measures on capital movements between Member States but also applies to restrictions on capital movements between Member States and third countries.[84]

IV. FOREIGN INVESTMENT CONTROL—MERGER CONTROL'S UNEASY BEDFELLOW

Outside the framework of a competition-based merger control assessment, public or national interest considerations are also taken into account under foreign investment controls in many jurisdictions.

Endesa, E.ON would acquire some of its assets. The EC cleared this transaction on July 5, 2007, *see* Case M.4685, decision on December 5, 2007, OJ [2007] C 212/04 and Commission Press Release IP/07/1858, 5 December 2007. Again, the transaction was notified to the CNE. The CNE went on to impose a number of conditions on the transaction, which the EC considered to be unlawful. When the Spanish government refused to withdraw the conditions, the EC again initiated proceedings for the breach of Article 21 EUMR as well as the free movement rules against Spain. In April 2008, the General Court rejected the Spanish application for interim measures suspending the EC's decision. Finally, in 2010, the Spanish government dropped its appeal to this decision.

[81] Nevertheless, some commentators have argued that the EC's record in preventing Member States from interfering with cross-border transactions is "rather bleak" and that it "lacks teeth." *See* further Gerard, *supra* note 66 and Davies & Jones, *Merger control and the public interest: Balancing EU and national law in the protectionist debate,* (to be published).

[82] EC press release no 277, *Mergers: Commission launches procedure against Poland for preventing Unicredit/HVB merger* (2006).

[83] Article 63 TFEU

[84] Davies & Jones, *supra* note 79, also with regard to possible justification grounds that can be invoked in respect of restrictions on capital movements between Member States and third countries.

A. Function, Evolution, and Impact of Foreign Investment Control

Over 130 countries now have competition regimes and in most of these regimes foreign investment controls and competition law operate side-by-side. In some countries the two instruments are operated hand-in-hand by the same agency, such as MOFCOM in China. While foreign investment controls are particularly prominent in countries at an earlier stage in economic development and with relatively new competition regimes, they also feature in mature economies with long established competition regimes, such as the United States, Germany, and the United Kingdom.

Foreign investment controls ("FICs") and competition law make for uneasy bedfellows, as the prime motivations are different and potentially conflicting. Where competition law is motivated by the desire to promote consumer welfare by subjecting producers to effective rivalry, foreign investment controls are typically motivated by the desire to protect domestic producers from competitors based outside the territory or by considerations unrelated to the economics of markets. FICs allow governments to block transactions that do not have an adverse impact on competition. Foreign investment control legislation often lacks a clear definition or guidelines against which a "national interest" criterion could be measured, making it more difficult to predict whether or not a proposed transaction might be blocked. This resulting uncertainty has been said, in and of itself, to dissuade pro-competitive transactions that may enhance consumer welfare.

B. "Foreign" Acquirers in a Globalized Economy

In addition to the potential pitfalls in controls of foreign investment there is also an inherent difficulty in identifying what "foreign" means in this context. Regardless of whether the relevant legislation's label is "merger control" or "foreign investment control," policy makers may wish to ask themselves what it actually means for investments or acquirers to be "foreign" in an increasingly globalized economy with companies operating across multiple jurisdictions with multi-regional headquarters and multinational shareholders and employees.

From a legal certainty perspective, the answer to "What is foreign?" is important as companies must be able to establish, based on transparent criteria, whether any given proposed transaction is likely to be subject to foreign investment control.[85] Likewise, policy makers and enforcement agencies need to be able to identify which acquisitions they should target through such rules. In order to do so, what amounts to a foreign takeover or a foreign company must be identifiable on the basis of objective criteria.

The difficulty of defining what is "foreign" results from the well-known phenomena whereby many companies today are active in more than one country, producing goods and creating employment across a number of jurisdictions. This can create a slightly cloudy picture when trying to place a company into a box of one particular country. For example, Apple, considered by many as the quintessential American or even Californian company, manufactures the majority of its products in China, where it employs 700,000 people compared to a total

[85] The French Decree No. 2005-1739, for instance, provides that the regulations also apply to French investors investing through foreign investment vehicles. The place of residence of a corporate investor is, in turn, determined by the place of residence of its ultimate beneficial owners, without regard to place of incorporation.

307,250 U.S. jobs supported by Apple.[86] Further, it is also one of the top ten companies by revenue in Ireland.[87] With such a wide employment reach, what corporate nationality most appropriately reflects its operations?

Notwithstanding commercial and employment activity across numerous countries, the ownership structure of companies can create further uncertainty regarding their true national identity, especially in a world with large foreign investments moving across borders leaving companies with a diverse range of patriated investors. For example Volvo, headquartered in Sweden and long identified as a Swedish company, was sold by Ford to Chinese car company, Geely.[88]

Even the seemingly simple and compelling criterion of the location of a company's headquarters has its pitfalls, particularly in a global economy where companies can and do shift their headquarters from time to time, often motivated by tax considerations. For example, in 2013, WPP, the global advertising company, moved its headquarters back to London, having previously moved its headquarters from the United Kingdom to Dublin in 2008. [89]

A recent study by *The Economist*[90] further illustrates the inherent flaws in a simplified classification of companies as either foreign or domestic. Its "domestic density index" combines the origin of revenue, employees, shareholders, and the nationality of the CEO. On those measures, AstraZeneca is only 12 percent British. The study notes that AstraZeneca paid no British corporation tax last year, just a quarter of the company is domestically owned, and the CEO is French. Pfizer, on the other hand, has a British CEO and—despite being a notionally American company—is only 49 percent American under the "domestic density index," largely a reflection of significant staff being employed and revenue generated in Europe and the rest of the world. Other companies assessed against the "domestic density index" include Alstom, only just over 33 percent French, and Vodafone, only 15 percent British.

C. Foreign Investment Controls in Selected EU Member States

While foreign investment measures and public interest considerations vary among the Member States, they are significant because, if taken together, they represent a number of considerations that may impact the result of a merger differently.[91]

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[86] *See*, *Why Steve Jobs was Disappointed in Obama,* BUS. INSIDER, (October 24, 2011) and Analysis Group Study February 2012, *available at* https://www.apple.com/about/job-creation/. *See* further the recent investigation by the EC in regards to the alleged state aid given by Ireland to Apple. Interesting to note is that on page 6 of EC's letter, which sets out the corporate structure of Apple, only the ultimate parent is incorporated in the United States whereas all of the other companies are incorporated in Ireland. European Commission Letter, State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP)—Ireland Alleged aid to Apple, page 6.

[87] *Top 1000 Our Guide to Irish Business*, IRISH TIMES (Oct. 7 2014), *available at* http://www.top1000.ie/companies.

[88] *Ford closes deal with China's Geely to sell Volvo,* MARKET WATCH, (March 28, 2010).

[89] *See* http://www.wpp.com/wpp/about/whoweare/history/, *see also, WPP investors vote to move back to UK*, FINANCIAL TIMES (December 11, 2012).

[90] *See*, *Companies and nationality – flags of inconvenience,* ECONOMIST, (May 17, 2014), *available at* http://www.economist.com/news/business/21602237-flags-inconvenience.

[91] Davies & Jones, *supra* note 79.

1. France

France's foreign investment rules are set out in Decree No. 2005 -1739 which provides that foreign investments in "strategic"[92] sectors must receive prior approval from the French Ministry of Economy. The French Minister of Economy can also intervene at the end of a second-phase merger investigation to take decisions based on public interest factors.[93] The sectors to which the regulations apply were recently expanded to include foreign investments (whether by EU or non-EU entities) in the fields of energy, transport, water, public health, and telecommunications.[94] This decree extending sectors deemed "strategic" was introduced while the French government were opposing the merger between GE and Alstom because Alstom was of "strategic importance" to France.[95] The then French Economy Minister Mr. Montebourg stated that the decree was a "choice of economic patriotism" and that "we can now block sales and demand conditions. It is an essential rearmament of public power."[96] To date, however, the decree has not been relied upon as a basis for formal intervention.

2. Germany

In 2009 Germany enacted foreign investment legislation that would enable the Ministry of Economics and Technology to investigate and potentially prohibit or impose conditions on an acquisition in any sector by a non-EU, or in some cases by an EU investor, on the grounds of public policy or security.[97] There is no requirement to notify and the Ministry can initiate its own investigation within three months of signing. To date, the German Ministry has not imposed any restrictions on foreign investment under this legislation.[98] However, the German government

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[92] The strategic importance of some of these sectors is questioned by some, *see* further Gerard, *supra* note 65.

[93] Davies & Jones, *supra* note 79 at 10.

[94] Decree No. 2014-479, dated 14 May 2014 and published on 15 May 2014.

[95] France's foreign investment rules are set out in Decree No. 2005-1739, (*see* also Articles L151-1 to L152-6 of the French Monetary and Financial Code) which provides that foreign investments in "strategic" sectors must receive prior approval from the French Ministry of Economy. There are stricter requirements attaching to non-European investments where the thresholds for authorization are lower and more sectors are covered. The review procedure takes two months and is suspensory. Approval may be conditional on remedies aimed at protecting the relevant national interest. The regulations also apply to French investors investing through foreign investment vehicles. The context for the introduction of these new categories was the French government's opposition to the bid by General Electric to acquire Alstom over concerns regarding job losses and the loss of an industry of "strategic importance" to France. The government eventually confirmed that it would grant the foreign investment authorization subject to it taking a 20 percent share in Alstom. *See* also *GE deal 'victory' for role of French state in economy,* FINANCIAL TIMES (June 23, 2014); *All over but the shouting,* ECONOMIST, (June 20, 2014); *A lot of bull,* ECONOMIST, May 7, 2014); *GE extends bid deadline for Alstom unit;* FINANCIAL TIMES (May 23, 2014); *France boosts say on GE bid for Alstom with takeover law,* REUTERS, (May 15, 2014); *French Set Conditions for G.E. Takeover of Alstom,* N.Y. TIMES (May 6, 2014).

[96] *French 'nuclear weapon' against foreign takeovers sparks UK blast,* FINANCIAL TIMES, (May 15, 2014).

[97] *Getting the Deal Through*, GLOBAL COMPETITION REV. (2013).

[98] Under the 2009 legislation non-EU investors acquiring 25 percent or more of the shares in a German company may be subject to an investigation by the Ministry of Economics and Technology which may ultimately prohibit the acquisition or impose conditions on the grounds of public policy or security. Investments by EU entities may also be caught by the regulations if a 25 percent or more shareholder is from outside the European Union. All sectors are caught to the extent that there is a threat to national security or public order. Parties are not required to notify foreign investments but the Ministry may initiate its own investigation within three months of the signing of

had previously approved a merger on public interest grounds that was found by the Bundeskartellamt to raise competition concerns.[99]

3. The United Kingdom

In the United Kingdom, the Secretary of State, under Part 2 of the Industry Act 1975, may prohibit a change of control of an "important manufacturing undertaking" if the change is contrary to the interests of the United Kingdom and relates to public policy, security, or health.[100] To date, this legislation has not been invoked to prevent any change of control.[101]

D. Foreign Investment Control in EU Member States: A Different Label Does Not Suspend the Primacy of EU Law and the Commission's Exclusive Jurisdiction

From a legal perspective, foreign investment control legislation enacted by EU Member States cannot serve as a "get out of jail card" to be played in circumstances where reliance on public interest tests under domestic merger control regimes would be in breach of either free movement rules and/or the EC's exclusive jurisdiction. To the extent that the free movement rules are engaged (bearing in mind the potential applicability of the free movement of capital rules to countries outside the European Union)[102] or the turnover thresholds under the EUMR are met, invoking foreign investment control rules may still fall foul of EU law.

E. Overview of Selected Foreign Investment Controls Outside the European Union

As noted above, foreign investment controls are prevalent in countries with relatively new competition regimes, but also feature in economies with a long history of merger control.

1. The United States

In the United States, the Committee on Foreign Investment in the United States ("CFIUS") reviews transactions resulting in foreign control of any U.S. business in order to identify whether there are any national security risks.[103] While "national security" is not defined,

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the agreement. It then has another two months to approve, prohibit or impose conditions on the deal. To pre-empt such an investigation parties have the option of applying for a non-objection letter.

[99] E.ON/Ruhrgas 2002. The Federal Minister of Economics and Technology can under the Competition Act intervene and authorize a merger that has been prohibited by the Bundeskartellamt, *see* further Davies & Jones, *supra* note 79 at 9.

[100] Under Part 2 of the Industry Act 1975 the Secretary of State may prohibit a change of control of an "important manufacturing undertaking" if the change is deemed by him to be contrary to the interests of the United Kingdom. In this context interests means interests that relate to public policy, public security, or public health. *See* section 13 of the Industry Act 1975.

[101] The compatibility of the Industry Act with EU law has at least indirectly been questioned by some, *see* for instance Davies & Jones, *supra* note 79.

[102] Davies & Jones, *supra* note 79.

[103] CFIUS reviews the transaction to identify any national security risk. The process is based on voluntary notification by the parties; however, should no notification be made the transaction is at risk from un-winding if found to be a threat to national security. *See* further Gotts, *Caveat Emptor: Transaction Parties Need to Consider Foreign Investment Laws as Part of Pre-Deal Planning*, (2014, to be published).

the Foreign Investment and National Security Act of 2007 ("FINSA") has clarified the factors considered, which include any effects on critical infrastructure and technology. [104]

2. Canada

In Canada, the Investment Canada Act applies to direct or indirect acquisitions of control of Canadian businesses by non-Canadian investors.[105] All non-Canadian investors have to file an application for review or a post-closing notification of the investment. Foreign investments that are above the relevant threshold will be reviewed under the substantive test of "net benefit to Canada" by the Investment Review Division of the Department of Industry, or the Department of Heritage if they involve cultural activities.[106] While the majority of transactions reviewed have been cleared, there has been a marked increase in reviews focused on national security or national interest, which has been argued to have coincided with a rise of economic protectionism.[107] As a direct reaction to the CNOOC/Nexon merger, the Canadian government announced in 2012 that any future acquisitions of Canadian oil sands businesses by SOEs would only be approved in exceptional circumstances.

3. Australia

In Australia, the Foreign Acquisitions and Takeovers Act 1975 ("FATA") governs foreign investments in Australian businesses.[108] It is administered by the Foreign Investment Review

[104] FINSA aimed at clarifying the factors to be considered in evaluating a transaction and include impacts on critical infrastructure and critical technologies that appears to be a less strict interpretation of national security. *See* further *Id*.

[105] *See* further, the Investment Canada Act, which also distinguishes between WTO and non-WTO investors, applying more preferential principles to the former, thereby recognizing the mutual relationship of trade between WTO membership countries, *supra* note 95 at 64.

[106] The Investment Canada Act applies to acquisitions of control of Canadian businesses by non-Canadians. All acquisitions of control, whether direct or indirect, by non-Canadians must be notified post-closing to the Investment Review Division of the Department of Industry. If the acquisition is found unlikely to be of a net benefit to Canada, the relevant minister has the power to prohibit the proposed investment or approve it subject to conditions. An example of an acquisition being rejected for failing to meet the net benefit to Canada test is the proposed bid by BHP Billiton for the Potash Corporation of Saskatchewan in 2010. Additional guidelines were issued in 2007 in respect of acquisitions of Canadian businesses by State-Owned-Enterprise ("SOEs") and subsequently updated in 2012 in the wake of the acquisitions by CNOOC (a Chinese SOE) of Nexon (a Canadian oil and gas producer, including an oil-sands business). This transaction was also cleared by CFIUS due to activities in the Gulf of Mexico. *See*, *CNOOC closes $15.1 billion acquisition of Canada's Nexen,* REUTERS, (February 25, 2014) and by Petronas (Malaysia's state owned oil and gas company) of Progress Energy. *See* further Goldman & Koch, *The Interface between Competition Law and Foreign Investment Merger Reviews: Flying Blind or with Radar? (*2014, to be published).

[107] "The last five years has seen more failed reviews in Canada than the preceding twenty," *see* Goldman & Koch, *id*.

[108]*See, Australia's foreign investment policy 2013,* Foreign Investment Review Board website. Amendments to the Foreign Acquisitions and Takeovers Act 1975 ("FATA") were made in 2009 intended to capture indirect acquisitions of control (or potential control) that may not be structured as a traditional share acquisition. If the relevant thresholds are met, the Treasurer (with advice from FIRB) then considers whether the acquisition is contrary to the national interest. The Archer Daniels/Graincorp decision (*see*, *Foreign investment application; Archer Daniels Midland company's proposed acquisition of GrainCorp Limited,* Press release by the Australian Treasury, 29 November 29, 2013) has been criticized in Australia for being made for political reasons and based on popular opinion rather than sound economic reasoning. A recent article analyzing the law in this area stated, "there is also little doubt that the National Party was hostile to the ADM bid." For example, the criticism of ADM by Deputy

Board, a non-statutory body that advises the Treasurer, who is the ultimate decision maker.[109] Transactions exceeding the relevant thresholds are subject to mandatory notification and can ultimately be prohibited or allowed with conditions if they are found contrary to the national interest. "National interest" is a wide concept and relevant factors include, but are not limited to, national security, competition, and certain Australian government policies such as taxes. In 2013, the proposed acquisition by Archer Daniels Midland Company of GrainCorp Limited was prohibited under FATA's national interest test even though it had previously been cleared on competition grounds by the Australian Competition and Consumer Commission.[110]

4. China

The Ministry of Commerce ("MOFCOM") is China's merger regulator and administers the merger control regime under the Anti-Monopoly Law. MOFCOM, or one of its local branches, is also responsible for granting approval for foreign investment in China. Foreign investment is also regulated on a sector-by-sector basis by MOFCOM as set out in the Foreign Investment Industrial Guidance Catalogue.[111] The Catalogue ensures that foreign investment is encouraged in some sectors, but is restricted or prohibited in other sectors.[112] Notably, in December 2013 MOFCOM initiated a process to revise China's three main foreign investment laws in order to reflect a system where some foreign investments require approval whereas others only require filing for record.[113]

5. Russia

The Russian foreign investment regime is primarily regulated by the Federal Law No 57-FZ, "On the Procedure of Making Foreign Investments in Companies of Strategic Importance for National Defense and State Security," which came into force on May 7, 2008, as amended in 2011.[114] The state will exercise prior control over any acquisition by a foreign investor of Russian companies that have strategic political interest for Russia and are active in sectors listed in the legislation.[115] Since the regime came into force, a substantial number of transactions are said to have involved a strategic political interest under the legislation.[116]

Legal advisers have commented that it has become more difficult in Russia for foreign investors to determine the scope of application of the law relating to foreign investment in

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Prime Minister and leader of the National Party Mr Warren Truss the night before Mr Hockey's announcement: "They haven't been offering anything to Australian growers other than higher charges and potentially even an environment which would make agriculture in this country the captive of overseas boardroom." Such criticism is summarized in *"Foreign Investment Law and Policy in Australia: A Critical Analysis,"* CLMR (February 2014).

[109] *See* further, http://www.firb.gov.au/content/who.asp?NavID=48.

[110] *See*, *ACCC to not oppose Archer Daniels Midland acquisition of Graincorp,* Australian Competition and Consumer Commission press release, (June 27, 2013).

[111] *Supra* note 95.

[112] US Department of State, 2014 Investment Climate Statement – China, 2014 http://www.state.gov/e/eb/rls/othr/ics/2014/228295.htm

[113] *Id.* Further, in September 2013, China established the Shanghai Pilot Free Trade Zone to test reforms to the investment registration regime and to open previously closed sectors to foreign investment and in November the Chinese Communist Party unveiled a reform agenda to broaden foreign investment access.

[114] Clifford Chance, *A Legal Overview of Foreign Investment in Russia's Strategic Sect*ors, (October 2012).

[115] *Supra* note 95.

[116] *Supra* note 112.

companies operating in strategic sectors. This is partly because a transaction may be subject to clearance even if the relevant entity's principal operations do not concern the strategic sectors, since ancillary involvement is sufficient to trigger the operation of that law. While very few transactions have been blocked by the clearing committee, the approval process and the delays caused by it are said to be a major concern for investors.[117]

V. WHAT EVIDENCE IS THERE OF FOREIGN INVESTMENT CONTRIBUTING TO ECONOMIC GROWTH AND CONSUMER WELFARE?

Turning back to the United Kingdom, what are the benefits of foreign investment to the United Kingdom? In considering possible legislative changes to the U.K. merger control regime in the aftermath of Kraft/Cadbury,[118] the Business, Innovation and Skills Committee noted, "any reform of takeovers in the United Kingdom has to that foreign direct investment is of great benefit to the UK economy."[119] But what evidence is there to support this assertion?

We have sought to summarize some of the literature surrounding the effects of mergers and acquisitions ("M&A") and foreign direct investment ("FDI"). The following provides a picture of some of the overall benefits that M&A and FDI might bring to the U.K. economy, based on the research of others. To do this, we assess the role of FDI in the United Kingdom and what effect this might have had on the economy. Finally, we consider recent literature on the effects of cross- border M&A, and of the effects of M&A activity more generally.

A. Foreign Direct Investment—Inbound

Globally, the United Kingdom has been one of the main beneficiaries of its traditional policy of "openness," attracting significant foreign investment. According to a recent report from U.K. Trade and Investment ("UKTI"), the United Kingdom attracts one of the world's highest amounts of FDI, second only to the United States.[120] Figures from the report show that mergers and acquisitions (including joint ventures), accounted for approximately 16 percent of all inward FDI in the United Kingdom for 2013/2014. This represents an increase from just over 13 percent last year and 10.5 percent the year before, with the overall level of investment on the rise over that period. This suggests that M&A activity is becoming an increasingly important avenue for FDI investment.

With a large amount of capital moving into the United Kingdom from abroad, there are several studies that have looked to assess the impact this has had on the U.K. economy. UKTI itself reports that an estimated 66,000 jobs were created by international companies investing in the United Kingdom in 2013/14, and 45,000 jobs safeguarded, based on recorded estimates at the

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[117] *See* Nourry & Jung, *Protectionism in the Age of Austerity – A Further Unlevelling of the Playing Field?*, 8(1) CPI ANTITRUST CHRON. 6 (August 2012).

[118] In January 2010, Kraft Foods launched a takeover bid for Cadbury. The takeover became front-page news and Cadbury actively resisted the takeover. The transaction was cleared by the EC subject to conditions. In the United Kingdom, however, the merger was critiqued by different commentators and there was talk of broadening the public interest test. In the end the public interest test was not broadened and the merger completed. *See* Seely, *supra* note 21.

[119] HC 234 2009-10 ¶¶ 74-5.

[120] UKTI (2014) Inward Investment Report 2013/14.

start of the project. These 111,000 jobs created by inward FDI highlight some of the positive effects that investment from outside the United Kingdom generates. [121]

An Economic and Social Research Council ("ESRC") survey of British businesses highlighted several overall positive effects from foreign ownership, although it also noted that these effects may vary by company and situation, with some individual communities experiencing both positive and negative consequences of foreign ownership.[122] The potential for some groups to be negatively affected by foreign investment will most likely increase their incentives to lobby against any individual transaction, irrespective of the overall potential gains of such a transaction to U.K. businesses and U.K. consumers.[123]

B. Outbound Investment

U.K. businesses are equally global in their investment outlook and are large investors in the outside world. The United Kingdom is one of the leading world economies for outwards investment, being second in the world in 2011, only to the United States.[124] According to recent studies, the United Kingdom owns £1.1 trillion in assets overseas, £300 billion more than the world owns in the United Kingdom.[125] A report by UKTI in 2014 reviewed the evidence on the effects of this and concluded that, on the whole, being one of the largest outward investors provides economic benefits, mostly through increased access to opportunities that would otherwise not be available, increasing productivity, profitability, and competitiveness.

Other evidence suggests that, on the whole, outward FDI also benefits the economy through effects on innovation and productivity. For example, a recent survey and empirical evidence by UKTI suggested that outward FDI provides overall productivity gains for the United Kingdom.[126] There is also some evidence of positive effects on employment within the United Kingdom itself through outward investment, although these are largely related to skilled workers, with the effect on low skilled works tending to be negative.

More generally, the available international evidence tends to suggest that overall employment effects from outward investment are neutral or even positive, suggesting that outward investment is not destroying jobs inside the country or region originating the investment as productivity and competitiveness gains outweigh any downscaling of domestic production.[127]

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[121] UKTI (2014) Inward Investment Report 2013/14.

[122] Economic and Social Research Council (ESRC) Evidence Briefing: Foreign ownership and consequences for British business, January 2011

[123] Although those companies benefiting from the deal will be incentivized to promote the potential gains, these are arguably often more difficult to communicate in an effective manner, as they threaten the status quo.

[124] HM Government, *Outward Investment—some economic proposals*, Trade and Investment Analytical Papers: Topic 15 of 18, (January 2014).

[125] Revised transcript of evidence taken before the Select Committee on Economic Affairs, *Foreign Takeovers and the Public Interest,* 8 (July 8, 2014).

[126] UKTI (2014) Inward Investment Report 2013/14

[127] *See*, for example, Copenhagen Economics (2010) Impacts of EU Outward FDI.

C. Cross-border M&A

UKTI figures show that around 16 percent of incoming FDI into the United Kingdom in 2013/2014 was through mergers and acquisitions, including joint ventures. Worldwide, cross-border M&A activity was valued at U.S. $349 billion in 2013, up from U.S. $332 billion in 2012.[128] Clearly then, M&A activity is significant.

Evidence[129] suggests that while there might be short-term difficulties for the target arising from a particular transaction, the overall effect is likely an increase in innovation—something that might well be expected to benefit consumers in the long-run (assuming effective competition in the markets involved).[130]

The British car industry offers a good example. Its glory days seemed all but over due to a lack of competitiveness until in the late 1980s. While other countries were seeking to shield their national car manufacturers from foreign acquirers, Britain adopted a different approach and openly welcomed investment by Japanese and other foreign investors. Some of these established new plants in green field sites, which began to introduce new practices and standards. Later, some British car marques were acquired by foreign companies including BMW (Mini and Rolls-Royce), SAIC (MG), TATA (Jaguar and Land Rover) and Volkswagen Group (Bentley). Some of these, with the new investment, experienced a remarkable turnaround. After observers had written off the chances of any auto manufacturer building substantial new facilities in the United Kingdom, Jaguar Land Rover is doing precisely that in Wolverhampton. Other "foreign" manufacturers, including BMW, Toyota, Nissan, Honda, and General Motors, are now building new generations of successful models in Britain. Recent reports suggest that this development is driving innovation: in hybrid and electric car technologies Britain is starting to gain some critical

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[128] *UNCTAD (2012) World Investment Report 2014: Investing in the SDGs: An Action Plan, page 18*

[129] *See* further: As well as the direct effects of cross-border acquisitions, M&A activity in its own right could produce benefits to the economy as a whole. Recent research by CASS business school showed that, in the short term, the effect of M&A activity significantly increased overall share value from combined firms. However, the long-term effect was more ambiguous, with the overall average effect suggesting an incre*ase in value for shareholders,* (Clare & Faelten*, Short term value creation from M&A in general, long term effects uncertain* (2014)). A similar, ambiguous story can generally be seen from the economic literature, with different studies yielding either similarly mixed or in some cases contradicting results. *See*, for example, Ravenscraft & Scherer, *The profitability of Mergers (1989)* compared to Ghosh, *Does operating performance really improve following corporate acquisitions* (2001). There is evidence to suggest that the effect of cross-border M&A is an overall increase in innovation as measured by patenting behavior, although this is appears to generally be based on innovative gains in the acquirer's country and may coincide with a reduction in the target country's innovation (Stiebale, *Cross-Border M&As and Innovative Activity of Acquiring and Target Firms* (2014)). Further, the research shows that the effect is largest when the pre-merger difference in innovation activities between target and acquirer is largest. The research also suggests that an increase in innovation is accompanied by growth in sales and productivity from the perspective of the merged entity. This is consistent with previous studies that have shown a benefit to the acquiring firm in innovation following cross-border M&A. *See*, for example, Bertrand & Zuniga, *R&D and M&A: Are cross-border M&A different An investigation on OECD countries* (2006).

[130] This research did not take into account potential effects arising from possible retaliation by other countries that might prevent innovation-enhancing deals taking place within their jurisdictions if their companies are denied investment opportunities.

mass, even a lead.[131] U.K. car production has risen to 1.6 million vehicles a year, with over 80 percent exported.[132]

D. Institutions and Trade Policy

One of the stated aims of the recent restructuring of the U.K.'s competition regime and authority was to increase business confidence through the predictability of the regime. [133]

It is widely recognized by international organizations that regimes facilitating cross-border mergers and FDI are important indicators of healthy economies. The OECD, as part of its monitoring of how regulation affects product markets in OECD and non-OECD countries, calculates indicators of market regulation. One of the negative indicators affecting a country's ranking covers restrictions to foreign investment.[134] Some recent research lends empirical support to the hypothesis that policy restrictiveness is a significant factor in determining bilateral M&A flows.[135] The same research highlights negative effects of policy restrictions on foreign investment.[136]

VI. COSTS AND RISKS OF DILUTING COMPETITION-BASED SCRUTINY OF MERGERS BY INTRODUCING OR BROADENING INDUSTRIAL POLICY-BASED PUBLIC INTEREST TESTS

In evaluating the merits of a potential (re-)introduction of wider or new public interest exceptions in the assessment of cross-border transactions, it is critical for policy makers not to lose sight of the potential costs and risks to U.K. consumers, businesses, and the overall economy such a shift in policy may give rise to. This section outlines some of these costs and risks.

A. Risk of Tit-For-Tat Closing of Markets—International Reputation And Relations

The evidence cited above suggests that the United Kingdom (even more so than other jurisdictions) benefits greatly from its open approach to foreign investment and an open market for corporate control.

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[131] *A resurgent British car industry offers lessons in how to improve other areas of our economic output*, INDEPENDENT (January 13, 2014).

[132] Department of Business, Innovation and Skills 2014 Growth Dashboard.

[133] BIS, *A competition regime for growth: A consultation on options for reform*, 2 (2011).

[134] *See*, for example, OECD, *Barriers to FDI: Restrictiveness of a country's FDI rules in 22 sectors in terms of foreign equity limitations, screening or approval mechanisms, restrictions on the employment of foreigners as key personnel and operational restrictions (e.g. restrictions on branching and on capital repatriation or on land ownership),* Economic Policy Reforms 2014 - Going For Growth Interim Report, Chapter 2 (2014) and *Reducing regulatory \barriers to competition: Progress since 2008 and scope for further reform*. The United Kingdom is one of the highest ranked countries in the 2013 rankings based on this Report.

[135] Barattieri et al., *Cross-Border Mergers and Acquisitions in Services, The Role of Policy and Industrial Structure*, The World Bank, Development Reasearch Group, Trade and International Integration Team (2014). Note that this research was limited to the services sector.

[136] However, the research also observes that this varies by state with high shares of manufacturing and, to a lesser extent, services in value added allowing the maintenance of restrictive policies while not necessarily deterring M&A.

Broadening the U.K. public interest tests may therefore damage the U.K.'s ability to attract investment from overseas, and damage the U.K.'s reputation internationally as an open, competitive place to do business. Even the perception of more interventionist tendencies may have a chilling effect on pro-competitive transactions. Ever more mobile capital and technology means that investors can pick and choose their activities globally, resulting in a greater need for countries to present themselves as attractive places for business to set up and expand within.

In addition, if policy makers were to introduce measures aimed at preventing politically sensitive takeovers on non-competition grounds, this may weaken considerably the ability of the United Kingdom to object to other jurisdictions contemplating similar measures. In fact, other states may be encouraged to use any legislative change re-politicizing merger control, for instance by introducing wider public interest tests, as a blueprint for their own legislative agenda. There could be a risk that such merger or foreign investment control would be applied on discriminatory grounds against U.K. companies seeking to do business in those states. U.K. companies conduct a significant amount of overseas investment and, therefore, stand to benefit from an open and efficient regime.[137]

B. Weakened Credibility of Regime and Damaged Business Confidence

Reintroducing political involvement in the assessment of mergers may encourage a belief that decisions on mergers could be influenced by political or lobbying considerations that could undermine the credibility of the regime and hurt business confidence.

In 2010, the then Secretary of State, Lord Mandelson, stated:

> Some have suggested that we should introduce some more open-ended public interest test that a government or arm's length authority should apply to takeovers. The reason I am unconvinced of the desirability of introducing such a test and equipping the Government with such powers is because I think that in those circumstances a government's judgment and intervention could be too exposed to political lobbying and short-term populist pressures which are unable to make an assessment of long-term growth and value that might come from the move. It might give rise to capricious decision-making of one sort or another, depending on the ministers and their official advisers, and it can lead to a loss of transparency and a loss of predictability which at the moment makes the current UK regime open to investors from which, I just underline, we benefit a great deal.[138]

[137] HM Government, *Outward Investment – some economic proposals, Trade and Investment Analytical Papers: Topic 15 of 18* (January 2014). It has been argued that the resurgence of industrial policy has already manifested itself in a wide variety of financial incentives in industrial countries and in leading emerging markets and also in the growing resort to local content requirements in developing countries, *see* for instance the article by Prof. Simon J. Evenett commenting on the recent breakdown of WTO negotiations: *No one is willing to tie their own hands*, FINANCIAL TIMES, (August 4, 2014).

[138] The work of the Department for Business, Innovation and Skills: Evidence given by Rt Hon Lord Mandelson, First Secretary of State, 19 January 2010, 10 March 2010 HC 299-i 2009-10 Q13, *see* also Antony Seely, *supra* note 21 at 14.

C. Defining the Public Interest—Policy Challenges and Risk of Intervention Creep

From a practical perspective, one of the main risks of resorting to a greater reliance on public interest considerations is the difficulty in defining them. The observation has been made that the unpredictable circumstances in which a public interest intervention might be perceived as necessary make it impossible to provide a satisfactory definition of public interest.[139]

If one could readily identify in advance those mergers that would not work out, the economic world would be a better place. However, given the strong incentives on the part of the merging parties and their investors and advisers to get a merger right, and the resources available to these groups, one must fairly conclude that overall it is extremely difficult to pick the winners from the losers in advance. Adding to this difficulty is that many mergers can take years to deliver their full potential, which can be contrasted with the very much shorter term that characterizes the modern media-political axis. Also *ex post* evaluation suggests that while in aggregate the gains from successful mergers exceed the losses from unsuccessful ones, there are significant numbers of "turkeys."[140] Cumulatively, this argues for a policy stance of studied neutrality and for a focus on removing anticompetitive features rather than second-guessing the whole rationale underlying merger transactions.

Although the investors and corporations find it difficult to identify in advance "winning" mergers, it is legitimate to ask whether it is any easier to identify in advance welfare-enhancing mergers that are in the public interest. As a competition authority, we know this is very challenging because we have had decades of operating such a regime in the United Kingdom before the reforms of the last 30 years. As well as the difficulties experienced by the financial and corporate communities in predicting which mergers would be acceptable to the public authorities, those authorities themselves found it difficult to identify wherein precisely lay the public interest. The Fair Trading Act 1973 required "all matters which appear to them in the particular circumstances to be relevant" to be taken into account. Would we be more precise today? While that would likely be the intention, once exceptions have been added, the pressure to add more such exceptions tends to build over time.

The concept of public interest is inherently elusive—however it might be defined, it is unlikely to cover precisely the next situation where intervention is considered an option. As such, there is a risk of either (i) a very wide exemption, operating as a catch-all, completely undermining the overarching structure of the existing framework, or (ii) the piecemeal addition of exceptions, risking fragmentation of the regime. Whenever a new public interest consideration is added, this may encourage lobbying to add further considerations, giving rise to the risk of intervention creep. Further fragmentation of the U.K. merger control system could result in inconsistencies, less transparency, and uncertainty for businesses.[141]

[139] *See* Stephan, citing the Lloyds/HBOS mergers as an example, *supra* note 20.

[140] Clare & Faelten, *M&A in the UK: a study of post-transaction shareholder wealth creation, company financial performance and employment*", (April 26, 2013).

[141] *See* Stephan, *supra* note 20 at 15.

The public interest definition problem is illustrated by a statement made by Brendan Barber, TUC general secretary, who argued for a "new balance" in merger regulation in the context of the Kraft/Cadbury takeover:

> At present, the only block on a takeover is whether it will work against the consumer. But we do not have to go back to the days when a vague public interest test allowed ministers to decide the fate of a takeover on a whim. Instead, we need a new kind of economic test handled by an independent mergers and takeovers commission. It would make bidders show that a takeover would be good for the target company. It would take into account the interests of the wider economy, employees, suppliers and local communities. Takeovers funded by unrealistic debt or driven by speculation would be unlikely to pass. Those that make industrial sense would.[142]

It is not clear which types of business models are preferable in the sense of being clearly more or less beneficial or detrimental from a consumer welfare perspective. Many questions arise that are relevant to the definition of public interest: What evidence is there to suggest that highly leveraged buy-outs are detrimental in the medium or long term? Is Government best placed to assess what level of capital expenditure under any given business model is preferable over another? Is Government best placed to assess the optimum level and location of R&D? Is what is good for the target company also necessarily good for consumer welfare?

Adding to the difficulty of a public interest test is that it is also unclear whether a hostile takeover is any more or less conductive to public interest than a non-hostile, friendlier, merger. In the case of a hostile takeover, the target company, which will by definition be against the transaction, will often influence the public debate by highlighting specific threats, which the acquirer might find difficult to counter, particularly if it is based abroad and has less influence over public opinion. In contrast, in the situation of a friendly merger the two involved parties, with all the necessary information available to them, will present an agreed front on the considerable benefits of the merger. This creates a potential information asymmetry between public opinion on hostile and non-hostile takeovers, not necessarily corresponding with the public interest.[143]

Highlighting further risks for protectionist tendencies in domestic economies, a recent paper on industrial policy and European merger control also reaches the conclusions that

[142] *Cadbury shows takeovers need reform,* GUARDIAN (February 22, 2010).

[143] Note the difference in public noise regarding the AbbVie/Shire and AstraZeneca/Pfizer mergers. Flemming Ornskov, Shire's chief executive, in relation to AbbVie's bid approach for Shire, "Everybody can show up and bid for Shire…It's an open capitalist market. I'm an acquirer myself." In contrast, AstraZeneca's chief executive, Pascal Soriot commented in relation to the attempted hostile takeover by Pfizer, "This potential merger would create a certain worry for me. You can imagine that our people are very focussed right now and a merger of this magnitude would create a distraction that potentially would delay some of our projects…The drawbacks are exactly what I was getting at a minute ago: the disruption. What will we tell the person whose father died from lung cancer because one of our medicines was delayed because, essentially, in the meantime, our two companies were involved in saving taxes or saving costs?" *See, Osborne's northern 'super-city' looks like a cynical vote-grab – but I'm all for it,* SPECTATOR (June 28, 2014) and Business, Innovation and Skills Committee, *Oral evidence: The Future of AstraZeneca*, HC 1286-I, Tuesday (May 13, 2014).

industrial policies aimed at promoting national champions raise serious risks of government failure, in particular by creating local dominant positions.[144]

These considerations demonstrate the slipperiness of the concept of public interest and the immensely difficult choices underlying policy decisions. Arguably it would be very difficult to introduce a test of the type Mr Barber argued for without opening up considerable uncertainty in the merger process.

D. Implications for the Competition Assessment

In recent public debate, concern has been expressed about the implications of any merger between AstraZeneca and Pfizer with specific regard to their R&D activity being carried out in the United Kingdom. As a consequence of this, the possibility of the inclusion of the protection of R&D as a public interest has been raised.[145] However, it should not be assumed without assessment of the merger-specific facts that such implications would not be taken into account in any event by an economics-based competition assessment. We note, for example, that in Google/Waze[146] the OFT assessed whether the merger would dampen Google's incentives to innovate. Moreover, in GSK/Pfizer[147] the OFT assessed the merger, in part, on its effect on research and pipeline innovation. And in AkzoNobel/Metlac[148] the U.K.'s Competition Commission took account of evidence on the impact of the merger on R&D. The EC has also assessed mergers, in part, on the basis of their effect on clinical research.[149]

E. Legal Risks

From the perspective of EU Member States, given the limitations arising from the legal framework within which policy choices can be made, there is a risk of being embroiled in years of expensive and distracting proceedings if measures preventing foreign takeovers were to be found to contravene EU law. In that situation, there is also a further risk of affected parties bringing potentially costly damages claims against the relevant Member State given the direct effect of the free movement provisions.[150]

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[144] Girgenson Geradin, *Industrial Policy and European Merger Control – A Reassessment,* TILEC Discussion Paper No. 2011-053 (October 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1937586.

[145] Seely, *supra* note 21 at 25-27.

[146] ME/6167/13 COMPLETED ACQUISITION BY MOTOROLA MOBILITY HOLDING (GOOGLE, INC.) OF WAZE MOBILE LIMITED, OFT decision published 12 December 2013, *see* in particular ¶¶ 26-28.

[147] ME/4136/09 Anticipated joint venture between GlaxoSmithKline plc and Pfizer Inc in relation to their respective HIV businesses, OFT decision published 21 July 2009.

[148] http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/akzo-nobel-metlac.

[149] Case M.5476 PFIZER/ WYETH, decision of 17 July 2009, OJ [2009] C262/1

[150] Difficulties in bringing such claims are set out in Davies & Jones, *supra* note 79.

VII. IN CONCLUSION, WHAT ARE THE MAIN HALLMARKS OF A SOUND, ECONOMICALLY EFFICIENT, AND DURABLE REGIME?

In summary, our analysis shows that the foundations of a sound merger control regime must, above all, consist of a rules-based system that (i) provides legal certainty; (ii) limits itself to minimal, economically justified distortions;[151] and (iii) thereby inspires business confidence.

The regime's credibility is enhanced by a technically competent, sufficiently resourced independent authority taking decisions on the basis of an economics-based competition assessment for which there is broad cross-party political support. Consistency and transparency in the decision-making process further strengthen investor confidence and minimize the risk of "tit for tat" closing of markets by trading partners.

Aside from attracting foreign investment for the benefit of the economy, a merger control regime that is based on sound competition economics can make companies, whether or not they are regarded as "national champions," more efficient and ultimately foster the creation of jobs and economic growth.[152]

There appear to us to be benefits for these considerations to equally be applied to foreign investment control rules such that merger and foreign investment control rules move in parallel. It would not appear desirable from a policy perspective for one legislative tool governing cross-border acquisitions to contradict or undermine another one. A re-introduction of criteria in foreign investment control that have previously been abandoned in merger control by successive governments would not only appear to be at odds with the lessons learned by those governments, but would also sit uncomfortably with the abovementioned business, consumer, and public confidence inspiring legal certainty and predictability.

We have sought to answer the question whether the U.K. merger control regime is in good health or requires treatment in the form of new or wider public interest considerations. The evidence suggests that the regime has evolved favorably and is capable of dealing even with extraordinary circumstances. The question for policy-makers, then, is whether any such increase in the use of public interest exemptions can bring benefits that would justify the potentially harmful side-effects.

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[151] The undoubted and often severe distortions of tax—both as regards specific national investment inducements, and the subsidizing of debt-finance by allowing tax deductibility of interest—were outside the scope of this article.

[152] *See* also Geradin, *supra* note 142; further side-benefits of a competition-focused regime have been highlighted by an OECD paper showing inverse relationship between competition and corruption, Tina Soreide, *Fighting Corruption and Promoting Competition,* Global Forum on Competition, OECD, (February 14, 2014).

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Protectionism or Legitimate National Interest?

A European Perspective on the Review of Corporate Acquisitions by Foreign Purchasers

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Protectionism or Legitimate National Interest? A European Perspective on the Review of Corporate Acquisitions by Foreign Purchasers

Rachel Brandenburger & Mark Jones[1]

I. INCREASING PROTECTIONISM IN EUROPE OR THE SAME OLD STORY?

In Europe, the question of whether there is, or should be, a role for national interest considerations in the review of corporate acquisitions by foreign purchasers has made headline news several times this year. In the Spring, Pfizer's proposed bid for AstraZeneca sparked concerns in the United Kingdom about whether the takeover of a U.K.-based company by a U.S.-based one would erode the U.K.'s national scientific research base and harm its standing not only in the United Kingdom but also globally.[2] Around the same time, concerns about General Electric's purchase of ALSTOM's energy business led the French government to expand its foreign investment approval rules to apply to an additional list of strategic sectors, and prompted an alternative proposal by Germany's Siemens to acquire the ALSTOM business and create a European champion.[3]

In addition to these specific examples, the continuing difficulties that the European economy is experiencing appear to be prompting a more general debate about broadening the basis for reviewing mergers beyond strict competition criteria in order to facilitate the creation of European champions better able to compete globally. For example, Germany's Chancellor Merkel and (then) French Industry Minister Montebourg have both publicly supported calls by some of the major European mobile telecoms companies to allow further consolidation in the sector.[4]

While this debate is currently taking place largely in political and media arenas, the existing supra-national framework of EU law that governs when and how EU Member States may intervene in mergers should not be overlooked. The overriding EU law principles establishing the European single market, and enforced by the European Commission, set limits

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[2] For example, the Secretary of State for Business,, Vince Cable, voiced concerns about the Pfizer bid, stating that the government would be "motivated by hard-headed considerations of the national interest" (*The Daily Telegraph,* May 6, 2014) and that one of the "options as the government would be to consider using [our] public interest test powers" (*Reuters,* 6 May 2014). Pfizer abandoned its bid for AstraZeneca in May 2014 following the rejection of its final offer of £55 per share by the board of AstraZeneca.

[3] GE responded by restructuring its offer to address the French government's concerns in order to receive its support.

[4] Chancellor Merkel advocated that a balance needed to be achieved between market power and competition so that European businesses "can score internationally" (*Financial Times*, May 8, 2014). Minister Montebourg spoke of the French Government's policy of "re-consolidating the sector" in France down to three operators (*Reuters,* April 9, 2014).

on the ability of EU Member State governments to intervene in cross-border deals. In particular, where transactions are subject to EU merger control rules, Member States have limited residual ability to intervene. For example, in relation to the proposed Pfizer/AstraZeneca merger, questions were raised over the legal scope for the U.K. government to intervene formally on public interest grounds in relation to the protection of domestic Research and Development ("R&D") and jobs.[5]

Several leaders of competition authorities in Europe have spoken out about the increased interest in economic protectionism. Outgoing European Competition Commissioner Joaquín Almunia has warned passionately against the dangers of intervention in antitrust enforcement, including mergers, on grounds other than competition throughout his five-year mandate.[6] Most recently, he has urged his successor, Competition Commissioner-designate, Margrethe Vestager, to "react strongly against the temptations of protectionism and of bad interventionism."[7] Vestager has been quick to take up the baton by publicly stating her desire to "resist any kind of politicizing of cases" and "keep protectionism at bay."[8] During her confirmation hearing before the European Parliament on October 2, 2014, she again rejected suggestions that competition laws should be relaxed in order to create European champions.[9]

Similar views have been expressed by national competition authorities' leaders. For example, Alex Chisholm, the Chief Executive of the new U.K. competition agency, the Competition and Markets Authority ("CMA"), has recently warned that "A re-politicisation by adding more exceptions to competitive-based merger controls, or introducing criteria in foreign investment control that have previously been abandoned in merger control by successive governments, could undermine business confidence and the credibility of any merger regime."[10]

There are many causes of this renewed focus on protectionism. The increased interconnection in the global economy, with greater cross-border trade flows and new sources of investment from Asia and the Middle East driving more cross-border M&A deals, is one factor. Within Europe (and elsewhere), with the still fragile state of many national economies following the financial crisis, there is also increased concern to safeguard jobs and foster national companies so that they are better able to compete internationally. Other factors include the apparently moribund state of the Doha round of World Trade Organization ("WTO") free trade

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[5] Commentators observed that a U.K. government attempt to apply a public interest test under its domestic merger control regime to Pfizer's approach to AstraZeneca would run into serious difficulties with the European Commission (*Daily Telegraph*, May 17, 2014).

[6] For example, in 2010 Almunia said "we also have to make sure that Member States do not seek to impose unjustified conditions on European takeovers, so as to protect national champions." (SPEECH/10/149, at the Confindustria Conference, *Liberta e Benessere – l'Italia al Futuro*, April 9, 2010). And in 2011 he stated, "regardless of where the bidders come from, EU merger control must remain anchored to its own rules and purposes. It is crucial to keep our merger review immune from non-competition considerations." (SPEECH/11/166, co-presented by the IBA Antitrust Committee and the European Commission, *Merger Regulation in the EU after 20 years*, 10 March 2011.)

[7] *MLex*, (September 19, 2014).

[8] *MLex*, (September 29, 2014).

[9] *MLex*, (October 2, 2014).

[10] Speech by Alex Chisholm at the Fordham Competition Conference, September 11, 2014.

talks, a recent trend for U.S. companies to undertake so-called corporate tax inversion deals, and the current domestic political climates in a number of EU Member States.

In fact, the debate between economic patriots and free market advocates in Europe is not new. Previous deals have also given voice to desires to intervene in foreign takeovers by (i) making greater use of existing public interest exceptions to the largely competition-based system of merger control across the European Union, (ii) increasing the scope and use of foreign investment approval regulations, or (iii) changing public company takeover codes.

Examples include the takeover of the British confectionary company Cadbury by the U.S. food conglomerate Kraft in 2009,[11] and the 2006 takeover of the steel producer Arcelor, which had been created from companies based in Spain, France, and Luxembourg, by its India-originated competitor Mittal. While some EU Member States such as France have appeared consistently more inclined to protect their national industrial and commercial bases,[12] the approach in others is less predictable and appears to be partly dependent on the government of the day and the broader climate of international relations. For example, in 2006, then U.K. Prime Minister Tony Blair was reported to have ruled out trying to block a possible bid for the U.K. gas supplier Centrica by Russia's Gazprom.[13] We rather doubt whether the same approach would be taken by today's U.K. government.

These periodic calls for change beg the question of how the EU system works. This is explained in the following sections of this article. We first provide an overview of how the current EU merger control framework accommodates both competition and non-competition considerations and delineates the discretion of EU Member States to intervene within a framework of EU law enforced by the European Commission. We then outline how this framework is complemented by the European Commission's responsibility for overseeing EU Member States' adherence to the EU law principles of freedom of establishment and free movement of capital.

II. EU MERGER CONTROL RULE LIMITS ON EU MEMBER STATES INTERVENING AGAINST FOREIGN PURCHASERS

Under the EU Merger Regulation ("EUMR"), the European Commission generally has exclusive jurisdiction over transactions that meet prescribed turnover thresholds designed to catch the larger cross-border deals. The European Commission is empowered to review such transactions solely on a competition-based test—whether the transaction will "significantly impede effective competition" in the European Union. Within this framework, the European Commission routinely reviews and approves transactions involving non-EU purchasers on the

[11] After that bid, the United Kingdom changed its public company takeover code to strengthen the position of target companies by allowing them to request more information from bidders about their plans in relation to matters such as jobs, factories, and headquarters.

[12] Eight years before the recent so-called "Alstom decree" expanding foreign investment approval rules, came what was dubbed the "Danone decree:" in 2006, following a rumored bid by the U.S. company PepsiCo for the French food and nutrition company, the French government introduced changes to the French takeover rules to make hostile takeovers harder.

[13] *Financial Times* (April 25, 2006).

same basis as those involving EU acquirers, including state-owned enterprises of non-European countries such as China.[14]

One of the limited exceptions to the European Commission's exclusive jurisdiction is Article 21 of the EUMR, under which EU Member States may intervene to take measures to protect specified "legitimate interests." Three categories of interest—public security, media plurality, and financial prudential rules—are identified as legitimate in the EUMR. The EUMR also provides for EU Member States to apply to the European Commission for further categories of legitimate interest to be recognized.

The European Commission has followed a strict approach to the operation of this exception, and taken action against EU Member States that have sought to intervene in mergers in violation of the European Commission's exclusive competence. Thus, EU Member States' ability to intervene in mergers on grounds other than competition is curtailed largely through enforcement of the European Commission's powers as a supra-national merger control authority.

This is well illustrated by the European Commission's response to Article 21 applications by the U.K. government for the recognition of interests relating to the regulation of utilities. In 1995, the proposed acquisition of U.K. based Northumbrian Water by Lyonnaise des Eaux (which had existing interests in the U.K. water sector) prompted the first approach to the European Commission by a Member State for recognition of an additional category of legitimate interest in relation to the U.K.'s special regime for review of water company mergers.[15] The European Commission approved this.[16] As a result, the United Kingdom can apply the regime alongside the European Commission's normal competition-based under the EUMR.

By contrast, in 1999 the European Commission rejected the U.K. government's application for a further legitimate interest in connection with Electricite de France's proposed acquisition of London Electricity.[17] The European Commission thus retained sole competence over approval of the merger so that the United Kingdom had no power to block the transaction, although the European Commission recognized that the U.K. energy sector regulator could impose regulatory conditions on the merged business relating to transparency and customer protection, outside the merger control process.

In several cases, the European Commission has intervened on the basis of a breach of Article 21 EUMR in order to prevent an EU Member State from attempting to block a merger falling within the European Commission's exclusive jurisdiction under the EUMR. The first of these was in 1999 in relation to Portugal's attempt to prevent the insurance merger between

[14] For example, in a speech at the Fordham Competition Conference in 2011 in which Competition Commissioner Almunia stressed that under the EUMR there was a level playing field for non-European companies, he pointed out that the European Commission had approved "a string of mergers" involving Chinese state-owned companies that year. (SPEECH/11/561, 8 September 2011).

[15] Under the U.K.'s water mergers regime, there is an assessment of the impact on so-called comparative competition, i.e. the detriment of the merger on the water sector regulator's ability to make performance comparisons in the industry as a result of the reduction in the number of water companies.

[16] European Commission decision of 29 March 1995 under Article 21(3) of Regulation EEC 4064/89.

[17] European Commission decision of 27 January 1999 under Article 21(3) of Regulation EEC 4064/89.

BSCH and A. Champalimaud on the basis, Portugal claimed, of a breach of its national financial rules.[18]

The long-running takeover battle between Germany's E.ON and Italy's Enel for the Spanish electricity company Endesa is perhaps the clearest demonstration of the European Commission's resolve to enforce Article 21 strictly. Both transactions fell within the European Commission's jurisdiction under the EUMR, and the Commission approved each of them on competition grounds. In each case, there were then moves by the Spanish energy (not merger control) regulator to impose onerous conditions on these bids, making it more difficult for them to proceed. But in three successive decisions—two in 2006 relating to first an initial, and then a modified, set of conditions which the national energy regulator sought to impose on the E.ON bid and one a year later relating to conditions put forward for the Enel bid—the European Commission concluded that Spain had violated Article 21.[19]

The operation of Article 21 is not relevant where the EUMR does not apply; in that situation the Member State concerned is free to apply its national merger control rules.[20] The approach of the national authorities to assessing the competition issues may vary from that of the European Commission.

This could be the case even if the national review framework is also competition-based. In the exercise of its discretion under a competition test, a Member State might, for example, be more inclined to prohibit a transaction involving a foreign acquirer than the European Commission, or to clear a merger that on a more stringent review by the European Commission might have been blocked—if, for example, there was a desire to create a national champion and/or forestall a foreign takeover.

This latter scenario was a consideration in the Endesa saga. Prior to the bids by E.ON and Enel, the first approach made for Endesa was by another Spanish energy company, Gas Natural. Endesa was opposed to this bid. In seeking to resist it, Endesa tried (unsuccessfully) to have the merger control review taken up by the European Commission, on the basis that the correct jurisdiction was the EUMR. This was because Endesa was concerned that the Spanish competition authorities would succumb to pressure from the Spanish government to approve the merger regardless of the extent of the competition issues.

A national competition authority might also wish to take account of non-competition factors in its review of the merger.[21] A case involving public interest issues as well as competition considerations was the acquisition of Lloyds by HBOS at the height of the financial crisis in 2008. This merger between two U.K. banks fell within the U.K.'s domestic merger control jurisdiction,

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[18] Article 21(3) European Commission decision of 20 July 1999 under Article 21(3) of Regulation EEC 4064/89.

[19] Article 21(3) European Commission decisions of 26 September 2006 and 20 December 2006, and 5 December 2007, under Article 21(3) of Regulation EEC 4064/89.

[20] The exclusive jurisdiction of the EUMR is not triggered in the case of mergers where the companies involved are not large enough to exceed the EUMR jurisdictional turnover thresholds or, even if large, achieve two-thirds of their EU turnover in the same single Member State.

[21] Although the European Commission could not stop this under Article 21 (since the EUMR would not be applicable), it could still take action under the free movement rules if such intervention did not come within one of the exceptions to them—see further below.

under which the U.K. government can override the competition-based assessment of the competition authorities on the basis of specified public interest grounds. Until then, it had been assumed that typically the public interest exception regime was to allow intervention in mergers that would not be prohibited on competition grounds alone. However, the Lloyds/HBOS merger was the reverse of this: it was approved by the U.K government on the basis of the critical need to maintain the stability of the financial system, in spite of the fact that it raised significant competition issues.[22]

With hindsight, some questioned whether this difficult judgment call by the U.K. government was made correctly. The intention was to avert the collapse of HBOS with wider systemic ramifications for the U.K. banking sector but, as it turned out, the combined bank still required financial support from the U.K. government. This bailout then required approval from the European Commission under the EU state aid (anti-subsidy) rules and, somewhat ironically, a condition of that approval, in order to help restore competition in the U.K. banking sector, was that Lloyds should sell off part of the merged business in order to create a new U.K. bank.

However, even if the merger had fallen under the EUMR such that the European Commission rather than the U.K. authorities had taken primary jurisdiction, it is questionable whether the European Commission would have sought to oppose the U.K.'s public interest intervention as contrary to Article 21 in a case such as this.

The European Commission's deployment of Article 21 of the EUMR reflects its commitment to breaking down trade barriers and promoting the single market within the European Union. Indeed, it is interesting to note that all of the Article 21 cases have involved mergers between companies based in the European Union, rather than non-European purchasers. However, in an increasingly globalized world, one can speculate that there could be cases where EU Member States are accepted by the European Commission as having legitimate interests in looking at non-competition factors arising in relation to mergers that involve non-domestic acquirers from outside the European Union as well as from another Member State. Cyber security, the protection of strategic technology, and security of energy supply are examples that might become recurring themes.[23]

III. CONSTRAINTS ON EU MEMBER STATES' INTERVENTION UNDER EU FREE MOVEMENT RULES

In the Endesa case, the European Commission also held that the Spanish attempt to impose conditions on the merger with E.ON was contrary to the free movement principles under EU law, demonstrating the European Commission's wider powers under the Treaty of the Functioning of the EU ("TFEU")—in particular, the principles of freedom of establishment and

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[22] In an expedited process, the U.K.'s Secretary of State for Business approved the merger in a decision dated October 31, 2008. The Office of Fair Trading's report to the Secretary of State of 24 October 2008 had found that the merger could reduce competition in relation to consumer current accounts, small business banking, and mortgage lending, but the Secretary of State concluded that the public interest in maintaining the stability of the U.K. financial system outweighed these competition concerns.

[23] Under EU energy regulatory rules, security of energy supply is already a relevant criterion for assessment of non-EU ownership of European gas and electricity transmission systems.

free movement of capital in Articles 49 and 63 of the Treaty[24] to oversee attempts by EU Member States to intervene in mergers on non-competition grounds.

A notable example of the application of the EU free movement principles with regard to corporate acquisitions is in relation to the holding of so-called "golden shares" by EU governments in strategically important privatized companies such as utilities. Golden shares usually give Member States veto rights over changes in ownership of the company. In a long line of cases, most recently in relation to golden shares held in Portuguese energy and telecoms companies, the European Commission and the European court have tested whether such shares were compatible with the free movement principles.

The European court has established strict criteria for when golden shares may be used to restrict takeovers: the basis must be grounds of public policy, public security, or overriding requirements of the general interest; the rights attaching to the golden shares must be operated in a non-discriminatory way; and they must be no more restrictive than proportionate. The cases have often turned on the application of the proportionality principle. For example, in 2003, the European court held that the golden share held by the U.K. government in the U.K. airport operator BAA did not satisfy the test and had to be removed,[25] making it possible for the Spanish company Ferrovial to acquire BAA shortly afterwards.

Thus, even outside the sphere of merger control rules, any attempt by an EU Member State to restrict non-domestic corporate ownership is likely to attract the European Commission's attention. It is noteworthy that only a small number of EU Member States have standalone foreign investment review laws and, as with the exceptions to competition-based assessment under national merger control rules, these are generally confined to criteria falling within the public policy, security, or general interest exceptions from the free movement rules under the Treaty.

IV. CONCLUSION

This article has provided an overview of the EU laws that set out the framework for the powers and roles of the European Commission and EU Member States in relation to the review of mergers by foreign purchasers. It has shown that, although there may be debate about the merits or otherwise of intervention against corporate acquisitions by foreign acquirers, there are in reality significant constraints—as a result of the supranational requirements of EU law—on the ability of EU governments to intervene in pursuit of such objectives. To that extent, opponents of protectionism may feel reassured.

It is interesting to draw the comparison with other market-based economies outside the European Union that have active foreign investment approval regimes that are not constrained by supra-national legal considerations. For example, in the United States, the Committee on Foreign Investment in the United States has the power to block foreign acquisitions of U.S. companies for national security reasons under the Exon–Florio Amendment to the Defense

[24] For a detailed review of the application of EU law in this area, we would recommend the paper produced for the Fordham Competition Conference 2014 by Alison Jones & John Davies, *Merger Control and the public interest: Balancing EU and national law in the protectionist debate,* (publication forthcoming).

[25] Case C-98/01 *Commission v. United Kingdom*.

Production Act 1950. In Canada, the government is able to review foreign acquisitions of Canadian companies applying a national net benefit test, under the Investment Canada Act 1985. In Australia, the Foreign Investment Review Board applies a national interest test to foreign acquisitions of Australian companies under The Foreign Acquisitions and Takeovers Act 1975.

There have been a number of high profile international mergers where decisions under these regimes rather than under competition rules have resulted in the transaction being blocked.[26] It is open to debate, given the fact-specific nature of any such review, whether the operation of these regimes without any equivalent to the EU law limitations on countries in Europe intervening in transactions may be said to reflect a more protectionist approach than has been taken in the European Union to acquisitions by overseas buyers. What can be said, however, is that separation of these foreign investment regimes from the relevant jurisdiction's competition-based merger control review helps to reduce the risk that calls for national protectionism influence the reviews conducted by the competition authorities.

Whether in the European Union or elsewhere, both foreign investment and competition or antitrust reviews share in common the need for predictability, consistency, transparency and speed in order to ensure the confidence of businesses, and ultimately consumers, in the enforcement powers which the authorities have been entrusted with.

[26] In 2006 the United States prevented the Dubai-based DP World from acquiring P&O, a U.K. company that operated a number of U.S. ports. In 2010 Canada blocked Anglo-Australian BHP Billiton from acquiring the Canadian fertilizer producer Potash Corporation. Last year Australia prohibited the acquisition by U.S. company Archer Daniels Midland of the Australian agribusiness GrainCorp.

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Protectionism in Merger Control:

Is the Process of Merger Control Adequate to Consider Wider Public Interest Issues? Is it Now Time for CFIEU?

Timothy R.W. Cowen

Protectionism in Merger Control: Is the Process of Merger Control Adequate to Consider Wider Public Interest Issues? Is it Now Time for CFIEU?

Timothy R.W. Cowen[1]

I. INTRODUCTION

Whether a broader public interest test should apply to merger control has recently been discussed by Alex Chisholm, CEO of the U.K. Competition and Markets Authority ("CMA"), after being raised at Prime Minister's questions during Pfizer's attempt to acquire Astra Zeneca. Similar issues also arose this year in France regarding General Electric's bid for Alstom. They are not isolated incidents and follow cases in many other jurisdictions that have come up over the years. They remind us that merger control by competition authorities is not the only source of control over mergers, and that public policy issues on mergers, and grounds other than competition grounds, do not go away.[2]

At the outset it is important to note that EU merger control is currently designed to investigate and assess competition issues. The legal tests against which the mergers are judged are based on competition law concepts such as whether the proposed merger would strengthen dominance in a relevant market or significantly impede effective competition. The people who administer the system, and those who work for merging parties, complainants, and others affected by mergers, have developed considerable expertise in the law and economics used to assess and determine whether a merger meets these tests. As a one-stop shop, the Commission only has exclusive jurisdiction to decide on competition grounds. Non-economic public interests are carved out[3] and have no place in the substantive tests. However, other public interests do arise and there is a process, addressed in Article 21 of the Merger Regulation, for Member States to take "appropriate measures" to protect other "legitimate interests."

[1] This article is written in a private capacity and not as a partner of Sidley Austin, or as a Member of the Competition Appeal Tribunal. The opinions expressed in this article are entirely personal and do not represent the views of Sidley Austin LLP or of any of its clients or of any other organisation.

[2] Indeed, grounds for intervention that have recently been mentioned as affecting the competitive landscape include access to personal data as a raw material, (raised by FTC Commissioner Julie Brill and accepted as a basis for review by the EU Commission in relation to the Facebook's acquisition of WhatsApp).

[3] Preamble (19) states: "... the exclusive application of this Regulation is without prejudice to Article 296 of the Treaty, and does not prevent the Member States from taking appropriate measures to protect legitimate interests other than those pursued by this Regulation, provided that such measures are compatible with the general principles and other provisions of Community law." Contrast this to the language in Article 3.2 of Reg.1/2003, which provides for an exception to the Commission's exclusive jurisdiction to authorize agreements under Article 101, in the event national legislation may pursue "predominantly an objective" which is different from that of protecting competition on the market.

Article 21 refers to legitimate interests and lists a few. What may be a public interest that is legitimate is not a closed list, and is subject to Commission assessment. Legitimate public interests can be notified in advance and can be added to over time.[4]

This system means that national controls over media plurality, defense, or other legitimate public interests continue to exist at national levels. Such issues are addressed by national officials under separate national regimes (such as the recent News Corp/Sky merger in the United Kingdom).

Wider public interest issues do continue to arise, posing a question about greater coordination being needed on their assessment and determination. This article briefly reviews some of the cases and issues that have been, or are being, raised. It accepts that the current system of merger control is ill suited to considering a wider public interest investigation or adjudication and that a wide public interest test is undesirable. However, a case can be made for a more coordinated EU system of parallel oversight, similar to that which operates in the United States, to consider other non-competition related public interests on investment within a merger control timetable. The current debate is outlined below, followed by a modest suggestion of how the system could be reformed for the future, which might form the basis for a discussion of the mechanism.

II. PUBLIC DEBATE AND INCREASING PROTECTIONISM?

In the past, a wide variety of government laws and measures existed—such as local content rules and foreign exchange restrictions—which are examples of measures designed to secure investment but which distorted trade in violation of the GATT and WTO agreements. The OECD and WTO monitor such measures and report on them regularly. According to the June 16, 2014 joint report from the OECD, WTO, and Unctad:

> The vast majority of trade-restrictive measures taken by G-20 members since the onset of the global financial crisis remain in place. While 1,185 trade-restrictive measures have been recorded since October 2008, only 251, or roughly one-fifth, of these had been removed by mid-May 2014 making the total number of measures still in place 934—up by 78 from the end of the last reporting period. Around 21% of the measures introduced since October 2008 had been removed by mid-May 2014, compared with 19.8% at the time of the previous G-20 trade report in December 2013. Thus, when viewed against the background of this pace of removal of existing restrictions, it is clear that overall trade restrictions have continued to accumulate.[5]

The report singles out two EU Member States—France and Italy—which had amended existing policies related to mergers during the reporting period. The French amendment extends

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[4] Article 21 of the ECMR.

[5] In addition it is noted that G-20 members put in place 112 new trade-restrictive measures during the period mid-November 2013 to mid-May 2014—slightly down from the 116 restrictive measures introduced in the previous period from mid-May to mid-November 2013. New import restrictive measures applied by G-20 members during the period under review affect 0.3 percent of G-20 merchandise imports or 0.2 percent of world merchandise imports. As in the past, the number of trade-restrictive measures applied by G-20 members during the period under review exceeds the number of liberalizing measures. However, the number of liberalizing measures taken during this period is larger than in the previous period, both in absolute and in relative terms.

the coverage of the existing review mechanism for inward foreign investment to six additional activities, including (i) energy supply (electricity, gas, hydrocarbons, or other sources of energy); (ii) water supply; (iii) transport networks and services; (iv) electronic communications networks and services; (v) operations for defense reasons; and (vi) protection of public health. It applies to safeguarding national interests in the areas of public order, public security, and national defense. As part of a security-related investment review mechanism created in 2012, the Italian measure establishes procedures for the exercise of special powers of the government in connection with investments in the defense and national security sector.

The statistics may imply a significant increase in trade restrictions and may indicate a growing protectionism, but they also may reflect other policy concerns that have the effect of restricting trade. Whether the restraints are expressions of legitimate public interests may in some cases be difficult to determine. The French government's decree[6] is listed by the OECD as potentially restrictive since it requires prior approval from the French Economy Minister for mergers or acquisitions, allowing it to block foreign takeovers of French companies in "strategic" industries; it was taken at a time intended to throw up a potential roadblock to General Electric's planned $16.9 billion bid for Alstom's energy assets.

Whether Alstom's energy assets truly are strategic is the central question. The European Commission warned France over the move:

> 'The objective of protecting essential strategic interests is clear when it involves security or public order and that is recognised in EU treaties,' said EU Commissioner Michel Barnier, 'But we also must check if this is applied in a proportionate fashion, otherwise it could amount to protectionism.'

By way of background, the recent French decree extended a pre-existing law from 2005. The French law itself was triggered following concerns in France about the way that the United States was using its defense legislation; in particular, following requests by members of the U.S. House of Representatives for a review of a proposed acquisition by China National Offshore Oil Company for Unocal Corp.

Whether a transaction is truly sensitive on strategic or security grounds also arose in the Dubai Ports case. In 2006 controversy erupted surrounding the attempt by Dubai Ports to purchase a number of major U.S. port management contracts from the British firm, P&O. In 2005 Dubai Ports approached the Committee on Foreign Investment in the United States ("CFIUS"), as part of a typical U.S. merger clearance process.[7] (CFIUS is the multi-agency U.S. federal panel that decides on deals involving non U.S. companies.) Some concerns had been raised by the U.S. Coast Guard during the CFIUS process. After assurances were provided by Dubai Ports concerning the security of port operations, CFIUS approval was provided, and the deal was completed.

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[6] Decree No 2005-1739 dated December 30, 2005 regulating foreign financial relationships, codified under Articles R153-1 *et seq.* of the French Monetary and Financial Code (the "CMF") and implementing Article L. 151-3 of the CMF.

[7] It should be noted that in certain industries such as telecommunications, CFIUS approval is a regular fact of life and has often resulted in conditions being imposed on the transaction.

Congress was then lobbied by a U.S. P&O partner, and congressional politicians questioned the approval and the terms of the assurances, raising concerns about the security of ports and risks from terrorism. A House Panel voted to block the deal. President Bush threatened to veto any legislation that attempted to delay the deal. Dubai Ports eventually avoided the issue by selling P&O's U.S. operations to an American business, AIG's asset management division, for an undisclosed sum.

Following the Dubai Ports case, Congress approved, and President Bush signed, a measure that was designated as P.L. 110-49 that alters the CFIUS process in order to provide greater oversight by Congress and increased reporting by the Committee on its decisions. In addition, P.L. 110-49 broadened the definition of national security and required greater scrutiny by CFIUS of critical national infrastructure.[8]

Since then, the CFIUS process has continued to operate, but not without criticism. In particular, concerns have been raised about its level of transparency and whether it adds an additional level of uncertainty to the outcome of transactions. Concerns have also been raised over acquisitions by foreign governments through sovereign wealth funds.[9,10]

One criticism is that the boundaries to the definitions of security and critical national infrastructure are not clear. For example, in the 2013 proposed acquisition of Smithfield Food by China's Shuanghui International holdings Ltd., questions were raised about the implications for U.S. critical infrastructure/key resources, about U.S. food security over the long-term, and whether such concerns were being addressed via a CFIUS investigation. Indeed, critical industries are defined very broadly.[11] These sectors include telecommunications, energy, financial services, water, transportation, and the "cyber and physical infrastructure services critical to maintaining the national defense, continuity of government, economic prosperity, and quality of life in the United States."[12] This appears to allow CFIUS to investigate and recommend conditions on matters well beyond traditional defense and security sectors.

From Fujitsu's failed deal with Schlumberger in 1987, which was the spur for Exon-Florio, to the most recent changes, technology transactions have been center stage, and the importance of technology and research and development has been reviewed many times. Indeed, one important development was brought about in late 2006 as a result of Alcatel's acquisition of Lucent technologies, following the Dubai Ports case. CFIUS and President Bush approved the

[8] It is important to note that PL110-49 continues to use the same standard as the Exon-Flori amendment of 1988, namely that the President must conclude that other laws are inadequate or inappropriate to protect national security and that there must be credible evidence that foreign investment will impair national security.

[9] Reflecting worries that echo the U.K.'s Lilley doctrine of the late 1980's (*see* footnote 15 below); what was once called "back door nationalization" and might now be described as "back door nationalization affecting critical national infrastructure."

[10] *See* James K. Jackson, CFIUS report, Congressional Research Service 7-5700 (March 2014), *available at* www.crs.gov RL33388.

[11] "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters." P.L. 107-56, Title X, §1014, October 26, 2001; 42 U.S.C. §5195c(e).

[12] 42 U.S.C. §5195c(b)(2), and (3).

acquisition but made that approval the subject of a controversial "evergreen" condition. Alcatel-Lucent was required to agree to a national security arrangement, known as a Special Security Arrangement, that restricts Alcatel's access to sensitive work done by Lucent's research arm, Bell Labs. It is an evergreen condition in that CFIUS is allowed to review and reopen approval of the deal at any time in the event of material non-compliance with the terms of the arrangement.

Pfizer's bid for Astra Zeneca in the United Kingdom in May 2014 would appear at first sight to be a transaction of a different type altogether. Pfizer made repeated offers, all of which were repeatedly rebuffed by Astra Zeneca. The minister responsible, Vince Cable, referred to the fact that under merger control the government could only intervene in certain areas such as defense and with relation to media interests or banking, but had limited powers when considering the scientific research base in the United Kingdom. The deal provoked political commentary in the House of Commons. This involved the Labour leader Ed Miliband, who said at Prime Minister's Questions that there should be a broader public interest test for mergers and that the U.S. company should guarantee jobs.

Ed Miliband's statement was against a background where Pfizer had accepted there would be job cuts and Astra Zeneca had made statements about risks of disruption to U.K. research and development activity and critical skills if the merging entity were to consolidate its operations among locations in the United Kingdom, Germany, and the United States. The government had obtained "assurances" on investment and jobs, which were then criticized by the leader of the opposition for their weakness, lack of enforceability, and for being "worthless." Kraft's bid for Cadbury was contrasted where, under the previous Labour government, assurances were given only to be followed by plant closures. The Labour leader argued that as a company worth two percent of British exports, and an employer of 30,000 people, Astra Zeneca was of strategic national interest.

Questions were raised in the press about whether "Public Security" could be interpreted as including the protection of public health supplies. This may be the crux of the issue. Are these not similar concerns to the U.S. approach to critical infrastructure or French concerns over strategic industries?[13]

Following Pfizer's public offer, which was made together with statements of the company's intention to provide assurances, the U.K.'s Takeover Panel has recently published a consultation on post-offer undertakings and intention statements. This sets out new proposals for the regulation of statements, made by involved parties, regarding an offer for a public company relating to any course of action that they commit or intend to take after the end of the offer period. The consultation is seeking views on these proposals and their enforcement,

[13] Or indeed, British concerns about energy security e.g. by Lord Puttnam in 2008, House of Lords, in the context of a potential Gazprom bid for Centrica, resisted by the Labour government on the basis that where a merger posed "a genuine and serious threat to what is described as societal needs such as energy supply" it would be covered by the provision in the 2002 act regarding national security. *See* Antony Seely, *The Public Interest Test*, HOC library paper SN 5374, page 11 (May 7, 2014).

ultimately via the courts.[14] This also highlights the extent to which EU merger control is, or is not, a one-stop shop. The consultation period closes on October 24, 2014.[15]

III. THE CURRENT DEBATE AMONG COMPETITION AUTHORITIES

After referring to the recent cases, Alex Chisholm, the CMA's Chief Executive, raised the following question at the Fordham conference in September 2014:

> These and other large international merger cases have revived a lively debate on the perennial question of the balance between industrial policy and the application of antitrust laws. Should we stick with a competition-based assessment by independent authorities? Or should the State reserve for itself the right to intervene in global deal-making, for instance in order to protect domestic jobs or particular aspects of a country's infrastructure? The question of whether such state intervention is beneficial, and if so whether best achieved through a widening of public interest tests in merger control, or by virtue of other legislative tools, including foreign investment control, continues to arise.[16]

Alex Chisholm also suggested that in the post-crisis economic climate, European companies "could be attractive targets for foreign buyers, driven by tax considerations."[17] Competition Commissioner Almunia has referred to "protectionist signals" on the French approach to GE Alsthom, among other cases, while also suggesting that data protection issues do have a place in EU merger control in the context of the Facebook/WhatsApp merger. [18]

To date, the discussion among competition authorities appears to emphasize free markets and their benefits. The current advocacy of the benefits of free markets appears to assume that the motivation for other controls may be suspect and may be motivated by protectionist tendencies. While it is reasonable to be skeptical, such advocacy may be beside the point if the motivation for additional controls is recognized within the system of the EU's "control" of mergers, and may be motivated simply by other public policy goals.

Current discussion tends to be cautious. It is influenced by the failure of the wide public interest test and the uncertainties that were created when that test was the basis for the Fair Trading Act in the United Kingdom, which is entirely understandable. In 2010, in considering the potential legislative changes on the Kraft bid for Cadbury, the then Secretary of State for

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[14] *See* 15th September 2014 the Code Committee of the Takeover Panel PCP 2014/2.

[15] The consultation on amendment to the takeover code follows various parliamentary debates and previous amendments made in the light of Kraft's bid for Cadbury, and the BIS Review or the Report by Professor John Kay of UK Equity Markets, *see* HC 603 2013-14 25th July 2013 and Seely, *supra* note 13 at 17 and 22.

[16] Alex Chisholm speech, *Public Interest and Competition-Based Merger Control* (September 11, 2014), *available at* https://www.gov.uk/government/speeches/alex-chisholm-speaks-about-public-interest-and-competition-based-merger-control).

[17] These concerns echo similar debates that have taken place in the past; for example, the Thatcher government's concern that its program of privatization could be undermined by foreign state-owned takeovers leading to "back door nationalization" was known at the time as the "Lilley doctrine" after the statements made by Peter Lilley, then Secretary of State for Trade and Industry.

[18] *See*, for example, statements of Commissioner Almunia (September 2014) on the Facebook/WhatsApp merger, the Commission's press release on that case on October 4, 2014, and the speech by the FTC's Julie Brill, *Weaving a Tapestry to Protect Privacy and Competition in the Age of Big Data* (June 2, 2014), *available at* http://www.ftc.gov/public-statements/2014/06/weaving-tapestry-protect-privacy-competition-age-big-data-address-european.

Trade and Industry, Peter Mandelson, was reported to have been "unconvinced of the merits of a broad public interest test because in those circumstances he thought a government's judgement and intervention could be too exposed to political lobbying and short-term populist pressures."[19] He added that such a move could lead to a loss of the transparency and predictability that made the current U.K. regime open to investors, from which the United Kingdom may well have benefited a great deal.

These are fair points but also may also miss the mark. Change has already taken place in the United Kingdom in recent times where non-competition grounds for intervention were considered to be paramount. For example, in 2008, in response to the financial crisis, Parliament approved intervention on a new public interest ground—the stability of the U.K. financial system—which was relied on to approve the Lloyds/HBOS banking mergers against the competition-based advice of the OFT. The case has been criticized and referred to as a response to exceptional events. It is based on one of the currently recognized additional legitimate grounds for review under Article 21, (prudential control) and, perhaps, should not be seen as part of a growing trend.

IV. DEFINITIONS AND PROCESSES FOR INFORMATION AND REVIEW WITHIN SENSIBLE MERGER CONTROL TIMEFRAMES, AND THE EMERGENCE OF SIFIS, NIS, AND CNI

Clearly, there is a need to ensure transparency and predictability within the system and to avoid protectionism. Independent oversight is needed to ensure that intervention only takes place on legitimate grounds, and that legitimate grounds are not being abused. To some extent this currently exists.

Article 21 of the Merger Regulation does provide a mechanism of oversight and review. Member States clearly can control mergers on grounds of public security, plurality of the media, and prudential rules. These are interests recognized as being legitimate ("recognised interests"). Measures genuinely aimed at protecting one of these recognised interests can be adopted without prior communication to (and approval by) the Commission, even if they are liable to hinder or prohibit a merger with a Community dimension, on condition that they are proportionate and non-discriminatory. Any other interest pursued by way of national measures liable to (i) prohibit, (ii) make subject to conditions, or (iii) prejudice a merger with a Community dimension must be communicated to the Commission before being implemented.

The requirement to obtain the Commission's prior approval applies whenever there are serious doubts that national measures are genuinely aimed at protecting a recognised interest and/or comply with the principles of proportionality and non-discrimination. The Commission must then decide, within 25 working days, whether the national measures are justified for the protection of an interest compatible with EU law.

Lack of clarity, and the prospect of real differences of views on whether a transaction is within the legitimate recognised interests grounds that can be dealt with at a Member State level,

[19] *See* speech of Alex Chisholm, *supra* note 16.

have been identified as issues by the Commission.[20] The timetable for notification may also be problematic. The Endesa saga is outlined below and is an example of deficiencies in the current system. In brief:

- In February 2006 E. ON announced its bid for Endesa. The bid was competing with a hostile bid that had previously been launched by Gas Natural, subject to national merger control.
- After the announcement of the E.ON bid, in late February 2006, the Spanish Council of Ministers adopted a new legislative measure increasing the supervisory powers of the CNE (Comision Nacional de Energia), the Spanish energy regulator.
- Under the new decree, E.ON's bid was subject to the CNE's prior approval. Previously, this authorization was not required as E.ON did not carry out regulated activities in Spain.[21] The CNE's decision made the proposed transaction subject to a number of conditions that may in part have been designed to protect and preserve the national infrastructure in Spain.[22]
- After examining these conditions and having invited the Spanish authorities to submit observations, on September 26, 2006 the Commission adopted a decision declaring that the Spanish authorities had breached Article 21, for failure to provide advance notification, declaring the conditions illegal under EU law.
- The Spanish Government took no action. The Commission was directed to take into account domestic proceedings and amendments to the conditions and, following a period of correspondence in early 2007, eventually took proceedings against Spain that were commenced at the European Court of Justice in April 2007.
- In March 2008, the European Court of Justice found that Spain had failed to comply with Article 21. E.ON had abandoned the public offer on April 10, 2007.

There is an emerging category of companies that may find they are subject to such special national treatment. Following the financial crisis in 2008 the U.S. administration designated certain entities, whose collapse would pose a serious risk to the economy, as systemically important financial institutions ("SIFIs"), and regulated them accordingly. The Basel committee on banking supervision in the European Union introduced new regulations, known as Basel III, that also specifically target SIFIs. The focus of these regulations requires increases in bank capital in an effort to ensure that they have a stronger financial basis for the future. The Commission has also proposed a further directive on network and information security ("NIS"), similarly based

[20] In (COM/2006/0779 final) the Commission noted: "Uncertainties persist regarding the scope of Article 296 TEC, which allows Member States to derogate from Internal Market rules when their essential security interests are at stake. Since the dividing line between defence acquisitions which concern essential security interests and those which do not is vague, it is not always clear which rules should apply to which contracts. In consequence, the application of Article 296 TEC remains problematic and varies considerably between Member States."

[21] EU Commission competition policy newsletter Number 2 2008. Application of Article 21 of the Merger Regulation in the E.ON/ Endesa case *Lucrezia BUSA and Elisa ZAERA CUADRADO* (1).

[22] However, the obligation to maintain Endesa's headquarters in Spain would be questionable on any assessment.

on the idea that certain activity provides critical infrastructure and entities operating in energy transport, banking, communications, and healthcare should be subject to additional rules.

Policy toward critical national infrastructure in the European Union is rooted in the European Programme for Critical Infrastructure Protection.[23] The definition represents a consensus drawn from the inputs of Member States. The definition is broad such that a range of activities may fall within the boundary of Critical National Infrastructure ("CNI").[24]

V. IS IT NOW TIME FOR CFIEU?

Many entities that are already providers of critical national infrastructures operate on a cross border—if not a global—basis, and much of our infrastructure is already owned by multinationals. The freedom to invest, and the open approach to investment adopted by many countries, may allow important infrastructure to be provided at low cost and to benefit from global economies of scale in the wider public interest. This may be one of the many benefits of free and open markets.

The impulse behind these regulations appears to derive from a similar impulse to that in the United States. It may be uncomfortable to admit, but the free play of market forces subject to merger control on competition grounds did not save the world from the financial crisis, and it has to be recognized that the financial system, with its propensity to internalize profits and externalize losses, has significant social consequences. An argument can thus be advanced for pre-notification in a merger review type of process in relation to further consolidation among SIFIs, providers of NIS' or CNI's, or other defined entities that are considered to provide some part of critical national infrastructure.

The impulse to control mergers of players operating such infrastructure through current controls at the national level in the European Union, such as in cases cited here referring to the national controls in the United Kingdom, France, Italy, or Spain, may, however, stem from a common root—a concern to control mergers that affect the big industries and infrastructure that are important to society. This may not have been articulated well in the past but these concerns may, in many cases, be described as concerns about what we are beginning to describe as critical national infrastructure.

A revised and transparent mechanism for oversight of the interpretation of these additional controls and other investor protection regimes, such as those that operate in France and Italy, might be adopted. This might be a way of ensuring consistent interpretation and independent oversight and add predictability for those caught up in these systems.

Given that merger control at the EU level only addresses competition issues, would the further combination of such bodies by merger be possible under a competition analysis but unacceptable against the objectives of the critical national infrastructure regimes that have so recently been introduced? How would we know?

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[23] *See,* for example, EU COM(2006) 786.

[24] Lessons for merger control may be learned from the U.K.'s 2013 Intelligence and Security Select Committee, which revealed "something of a disconnect between the UK's inward investment policy and its national security policy" and commented that the processes were "far too haphazard an approach given what is at stake." On definitions, for example, *see* https://www.gov.uk/government/.../telecommunications-sector-intro.pdf.

VI. PROCESS CHANGES?

As Alex Chisholm has said:

> Foreign investment controls and competition law make for uneasy bedfellows, as the prime motivations are different and potentially conflicting"...and… "In so far as the future scope and weight of public interest considerations are concerned, it would appear desirable for both merger and foreign investment controls to move in parallel, rather than working against each other.

However, if nothing is done to ensure that the controls move in parallel, political concern will continue to be raised, and pressure will be brought to bear on transactions. An alternative to the range of national controls might be consideration of transactions at the EU level in a parallel procedure addressing transactions affecting critical national infrastructure, and possibly other legitimate public interest grounds, and the process might operate "in parallel" within merger control timetables and within defined processes.

The proposal would be to state that these non-economic public interest issues ought to be named, defined, and addressed in a publically accountable and transparent system. Protectionism may then be more readily avoided, and predictability improved for all concerned. Considering that the primary focus of merger control is currently on competition grounds, and the alternative will be ad hoc national intervention on a variety of grounds, perhaps there should be a Committee on Foreign Investment in the European Union? Perhaps this could be addressed in the current consultation on revisions to the EU Merger Regulation?

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Pfizer/AstraZeneca and the Public Interest: Do U.K. Foreign Takeover Proposals Prescribe an Effective Remedy?

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Pfizer/AstraZeneca and the Public Interest: Do U.K. Foreign Takeover Proposals Prescribe an Effective Remedy?

David Reader[1]

I. INTRODUCTION

When U.S. pharmaceutical giant Pfizer sought to acquire its U.K.-listed counterpart AstraZeneca earlier this year, much discussion centered around the possible adverse impact that the merger could have on the U.K.'s science base, particularly in light of Pfizer's questionable track record for asset-stripping and cutting investment in Research and Development ("R&D"). Although the proposed £69 billion (U.S. $117 billion) takeover ultimately crumbled, the prospect of Pfizer returning with an improved offer in the near future has led many to ask whether the United Kingdom should adopt a tougher stance on foreign takeovers that threaten the national interest. The U.K.'s Business Secretary, Vince Cable MP, has since proposed new safeguards to counteract these perceived threats;[2] but do they represent the best course of action in practice?

II. THE BUSINESS SECRETARY'S PROPOSALS

A. Remove Scope for Firms to "Wriggle Out" of Their Commitments

In the first of three proposals, Cable seeks to ensure that bidding firms adhere to the commitments they make in relation to a takeover by—in his words—removing the "wiggle room" that exists within the current procedure. Indeed, despite the existing rules obligating firms to abide by any commitments they make during the bidding process,[3] firms can renege on these commitments where a "material change of circumstances" arises.[4] Cable perceives this to be a "get-out clause" that acquirers are able to exploit in order to backtrack on their commitments after a takeover has been finalized.

The act of firms backtracking on their commitments, even where there has been a material change of circumstances, is a controversial subject in the United Kingdom. In 2010, Kraft Foods, the American grocery manufacturer, launched a successful takeover of U.K.-based confectioner Cadbury. At the pre-authorization stage, Kraft made a commitment to maintain operations at Cadbury's Somerdale factory in the West of England, which Cadbury had been in the process of closing down. The commitment was particularly attractive given that it would ensure the continued employment of some 400 workers at the plant. However, once the takeover had been completed and Kraft's management were in a position to speak to Cadbury about the

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[2] Vince Cable, *Strengthening confidence in the UK's takeover laws*, LIBERAL DEMOCRAT VOICE (July 2014), *available at* www.libdemvoice.org/vince-cable-writesstrengthening-confidence-in-the-uks-takeover-laws-41522.html (accessed July 14, 2014).

[3] This obligation persists for 12 months or a period otherwise specified.

[4] The City Code on Takeovers and Mergers, Rule 19.1.

planned closure, it became apparent that keeping the Somerdale plant open was not financially viable. The factory was closed at the beginning of 2011 and this arguably coincided with the emergence of a deep-set suspicion towards foreign takeovers by much of the U.K. population.[5]

The removal of the material change of circumstances clause would seemingly prevent firms from backtracking on their pre-takeover commitments in this way. But it seems wholly disproportionate to remove the clause in its entirety. Its existence is, after all, a testament to the fact that there will sometimes be legitimate commercial reasons for firms to depart from their commitments, such as in times of unforeseen austerity or major regulatory reform.

In a similar vein, the Kraft/Cadbury case illustrates the difficulties an acquiring firm faces when making commitments before it has seen the target company's confidential accounts and other relevant documents. Without the luxury of being privy to these documents, acquiring firms are prone to make commitments that (unbeknownst to them) are unworkable or unviable in practice. In the face of this information asymmetry, the material change of circumstances clause is one of the few legal provisions offering protection to the acquirer.

Given that the existence of the clause can be seen to serve a legitimate purpose, Vince Cable should perhaps consider alternative ways of ensuring that it is not exploited by firms with fraudulent motives. Fundamentally, the law needs to recognize the distinction between (a) a firm that makes commitments in good faith but is unable to honor them for an unforeseen commercial reason, and (b) a firm that makes commitments as a façade to complete the takeover and that has no intention of honoring those commitments. The former should be able to legitimately take advantage of the clause whereas the latter should not. In practice, it may be possible to frame this as a legal test, whereby a firm would need to meet certain criteria in order to be considered legitimate for the purposes of applying the material change of circumstances clause.

B. Introduce Financial Penalties for Firms Who Fail to Comply

The Business Secretary's second proposal is to introduce tough financial penalties for firms who fail to honor the commitments they have made. At present, the harshest sanction the U.K. Takeover Panel can impose for such infringements are so-called "cold-shoulder" penalties,[6] which prevent individuals from working on any takeover-related activity in the United Kingdom for a fixed period of time. Aside from some loss of reputation, the firms themselves face few repercussions as a result of reneging on their pre-takeover commitments.

Cable's financial penalties proposal would offer one such repercussion but it faces a number of obstacles in terms of deterring such behavior. For instance, it is unclear how these penalties would be calculated and how high they would need to be in order to constitute a genuine deterrent. When one considers the tax savings that Pfizer was due to inherit as a result of

[5] A recent survey found that 39/100 U.K. respondents consider foreign investment to be desirable, whereas 53/100 deem it undesirable. Pew Research, *Faith and Skepticism about Trade, Foreign Investment*, *available at* www.pewglobal.org/2014/09/16/faith-and-skepticism-about-trade-foreign-investment/ (accessed September 16, 2014).

[6] *Id.*, Section A, Part 11(b)(v). The Panel may also make a referral to the High Court under s. 955 of the Companies Act 2006 but this is, as yet, untested.

its merger with AstraZeneca (estimated at £1.4 billion (U.S. $2.3 billion) a year by one source),[7] one begins to appreciate how even a multimillion-pound fine could represent a mere slap on the wrist for an acquiring firm that backtracks on its commitments.

Moreover, these fines would need to be capped to avoid having an adverse effect on the key national interests that the policy is seeking to protect. For example, take the hypothetical scenario where Pfizer has successfully acquired AstraZeneca. The U.K. Government has been able to secure commitments from Pfizer to maintain the merged entity's investment in the R&D of pharmaceuticals (a key national interest). Pfizer later reneges on this commitment and the Takeover Panel takes steps to impose a significant financial penalty on Pfizer. The issue here is that, if the merger has resulted in Pfizer and AstraZeneca becoming a single economic entity, the fine effectively penalizes both.[8] Depending on the severity of the fine, the merged entity may be forced to offset the cost of the fine by further reducing its investment in R&D.

Imposing a cap on such fines is somewhat analogous to the rationale that underpins the way fines are calculated and capped for cartel offenses under EU competition law. For example, when calculating fines for breaches of Article 101(1) TFEU,[9] the European Commission will take account of a firm's (in)ability to pay a fine,[10] mindful of the fact that fining a firm into insolvency would result in a competitor exiting the market (which would be counterintuitive to its pro-competition policy aims). Of course, cartel enforcement is also a prime example of how different authorities have combined both corporate and personal sanctions, as well as civil and criminal penalties, in an effort to effectively deter wrongdoing. It is interesting to consider whether Vince Cable's proposal for financial penalties would need to be reinforced by an additional personal sanction for directors in order to act as an effective deterrent. Equally, it may be worth considering the possibility of forced divestiture as a separate sanction for firms who renege on their takeover commitments. These sanctions are not without their practical limitations, but they at least demonstrate alternative ways of pursuing deterrence without compromising key national interests.

C. Utilize the Public Interest as a "Last Resort"

Vince Cable's third proposal seeks to amend the public interest provisions for merger control under the Enterprise Act 2002. He recommends the use of a public interest test as a "last resort" measure that will only be utilized in cases where bidders refuse to undertake satisfactory commitments to protect the national interest. Exactly how Cable intends to achieve this is unclear,[11] but he told the BBC[12] that he would favor narrow and specific powers that would allow

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[7] Business, Innovation and Skills Committee, *The Future of AstraZeneca* (HC 2013-14), Q64. *Available at* *http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-innovation-and-skills-committee/the-future-of-astrazeneca/oral/9564.html* (accessed July 16, 2014).

[8] Pfizer may, however, wish to keep the two companies separate (as a parent-subsidiary relationship); in which case, the principle of "separate corporate personality" under U.K. company law would see Pfizer bear the full force of the fine. *See, Salomon v A Salomon & Co Ltd* [1897] AC 22.

[9] Consolidated Version of the Treaty on the Functioning of the European Union [2010] OJ C83/47.

[10] Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No 1/2003 [2006] OJ C210/02, at ¶35.

[11] Interestingly, Vince Cable—as the U.K. Business Secretary—could exercise his residual power to propose new public interest grounds under section 58(3) of the Enterprise Act. Subject to Parliamentary approval, this could

the Government to intervene and block mergers that were "very clearly against the national interest" (citing the loss of R&D and pharmaceuticals as clear examples).[13]

Of course, Cable appreciates that any such intervention on public interest grounds would need to comply with EU law if the merger meets certain turnover thresholds prescribed in the EU Merger Regulation ("EUMR"). Indeed, it follows that many mergers which are capable of having a clear adverse impact on the national interest will also be trading on a scale that would surpass these thresholds. In practice, the European Commission adopts a strict competition-based approach when assessing the legitimacy of mergers brought before it. However, Article 21(4) EUMR provides that Member States may assume the jurisdiction to rule on EU-level mergers that are likely to have an impact on their legitimate national interests.

There does, however, appear to be a very high threshold for what constitutes a "legitimate interest" for the purpose of Article 21(4). The EUMR lists three explicit legitimate interests (public security, media plurality, and prudential rules) and also allows Member States to suggest additional interests on a case-by-case basis. The fact that Member States can propose additional interests would appear to make Vince Cable's proposal workable in theory, but—after a series of cases between 1999 and 2008 which saw several Member States invoke Article 21(4) for illegitimate purposes—the Commission now appears to treat legitimate interest claims with a great deal of suspicion.

But even if one assumes that Cable's new public interest test is compatible with EU law, there remains scope for firms to abuse this procedure. For example, if an acquiring firm genuinely believes that its takeover is likely to be blocked on public interest grounds, then that firm will naturally seek to offer satisfactory commitments to avoid this outcome, even if it has no intention of fulfilling those commitments. By the time the firm begins to renege on its commitments, the merger would already be complete and the option to block the merger on public interest grounds would no longer be available. The firm, meanwhile, would escape with a financial penalty established by Cable's second proposal. As such, relying on the public interest test as a last resort measure would therefore necessitate a difficult assessment of a firm's trustworthiness as well as the quality of its commitments.

Any decision to extend the application of the public interest exceptions under U.K. merger control should be taken with the utmost scrutiny. By enabling an independent competition authority (the Competition and Markets Authority) to assess mergers according to their effect on competition, the U.K. merger control regime has all the ingredients necessary for transparency and predictability. This makes it a very attractive place to invest and do business. The public interest exceptions to the default competition-based approach (national security,

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create the specific intervention power(s) that Cable is referring to, without the need for new primary legislation. *See* David Reader, *UK public interest mergers: uncertain times ahead*, 26 CCP RESEARCH BULL. 18 (2013), *available at* www.competitionpolicy.ac.uk/documents/107435/107588/CCP+Research+Bulletin++Autumn+2013.pdf/951d8635-c00f-495b-9718-53a28358c099 (accessed July 20, 2014).

[12] *Vince Cable: UK to remove takeover 'wiggle room'*, BBC NEWS, *available at* http://www.bbc.com/news/business-28282621 (last accessed October 8, 2014).

[13] The Andrew Marr Show, *Interview: Vince Cable MP, Business Secretary* (July 2014). A full transcript is *available at* http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/130701.pdf (accessed July 14, 2014).

media plurality, and financial stability) very much resemble the legitimate interests listed under Article 21(4) EUMR at a European level. To add to the list of domestic exceptions—even as a last resort—would mark a step beyond the European norm and would carry the risk of compromising the openness and credibility of the U.K. regime in the eyes of the global marketplace.

This is not to say that there are no justifiable grounds for adding to the list of public interest exceptions in the future. Over time, the factors that are deemed to be "in the public interest" are subject to change, particularly in light of changing social attitudes and economic projection. A merger transaction may yet arise where it is, indeed, objectively justifiable to intervene in order to safeguard the public interest from a firm (be it domestic or foreign) that is not prepared to offer adequate commitments. But should Cable's proposal materialize in practice, it is imperative that new public interest exceptions are not introduced as a mere quick fix to address a solitary public interest concern at the expense of competition principles.[14]

III. CONCLUSION

Depending on what emerges from the Government's consultation on these proposals, it is possible that the first two of Vince Cable's suggestions will be introduced before next year's General Election.[15] However, based on the aforementioned discussion, there are doubts over whether these proposals would stand up to the task of safeguarding the national interest and, more centrally, whether it is even necessary or desirable to seek such safeguards in the wake of Pfizer/AstraZeneca.

With regards to the financial penalties proposal, in particular, it will be interesting to see whether alternative penalties (e.g. forced divestitures or personal penalties associated with cartel enforcement policy) will also be discussed during the consultation. If financial penalties fall short of providing an effective deterrent to firms reneging on their commitments, then Cable's first and third proposals become equally ineffectual.

Furthermore, at a fundamental level, the United Kingdom must ensure it takes every step to preserve its reputation as a nation that is open for business. There is often a fine line to be drawn between measures that seek to protect the national interest and those that go further to promote economic patriotism. The European Commission has itself become increasingly more vigilant towards Member States who have implemented *ex ante* measures to artificially control or frustrate cross-border mergers.[16] France remains under close scrutiny from the Commission for its own new foreign takeover laws;[17] the United Kingdom can expect to endure similar scrutiny should Cable's proposals come into force.

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[14] Bruce Lyons, *Competition Policy, Bailouts, and the Economic Crisis*, 5(2) COMPETITION POL'Y INT'L 25, 47, note 47 (2009).

[15] If legislation is required, Cable is set to utilize the Small Business, Enterprise and Employment Bill 2014-15 as a vehicle for the reforms.

[16] *See* Michael Harker, *Cross-Border Mergers in the EU: The Commission v The Member States*, 3(2) EUR. COMPETITION J. 503 (2007).

[17] Ingrid Melander & Foo Yun Chee, *France says won EU backing on takeovers law, EU says will monitor*, REUTERS, a*vailable at* http://uk.reuters.com/article/2014/07/10/uk-france-mergers-idUKKBN0FF1HW20140710 (accessed July 15, 2014).

Ultimately, for the United Kingdom to return to an interventionist approach to merger policy and takeover policy would be completely undesirable,[18] not least for the protectionist message it sends to overseas investors which the U.K. economy derives significant benefits from.

[18] *See* Andreas Stephan, *Did Lloyds/HBOS mark the failure of an enduring economics-based system of merger regulation?* 62(4) NORTHERN IRELAND LEGAL Q. 539 (2011).

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How the Proposed Payments Legislation Will Restrain Competition Among Payment Card Schemes and Harm Consumers in the European Union

David S. Evans (Global Economics Group, University of Chicago)

How the Proposed Payments Legislation Will Restrain Competition Among Payment Card Schemes and Harm Consumers in the European Union

David S. Evans[1]

I. INTRODUCTION

The European Parliament, in early April 2014, endorsed and further extended draft legislation,[2] originally proposed by the European Commission, which will impose sweeping regulation on payment card businesses.[3] The backers of the legislation claim that it will nurture competition, innovation, and consumer choice in the European Union.[4] In fact, if adopted in the current form, it will reduce competition among payment systems in the EU, impede the entry of new schemes, weaken innovation, and decrease consumer choice. European consumers will end up paying billions of euros more in fees. The legislation will squelch virtually all challengers to MasterCard and Visa.

One doesn't have to speculate about these effects. There are already dead and wounded victims in plain sight. The European Commission's recent policies have eliminated the most serious emerging pan-European challenger to the global card networks. A group of 24 banks drawn from across major countries in Europe tried to start a competing pan-European card system a few years ago. After being rebuffed by an intransigent Commission, set on shifting the cost of payments from merchants to consumers, the Monnet Project folded in April 2012. Several other attempts are all but shuttered. European consumers have already lost competition, choice, and innovation as a result.

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[2] European Parliament, "Amendments adopted by the European Parliament on 3 April 2014 on the proposal for a directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC (COM(2013)0547 – C7-0230/2013 – 2013/0264(COD))". April 3, 2014. Available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2014-0280+0+DOC+XML+V0//EN

[3] The Commission's initial proposals are currently being considered by the European Council, before Trialogue discussions commence at the end of 2014, or beginning of 2015, with a view to finalizing the legislation for adoption by the European Council and European Parliament.

[4] European Commission, "Proposal for a Regulation of the European Parliament and of the Council on Interchange Fees for Card-Based Payment Transactions". COM(2013) 550 final. July 24, 2013. Available at: http://www.ipex.eu/IPEXL-WEB/dossier/document/COM20130550.do; European Commission, "Proposal for a Directive of the European Parliament and of the Council on Payment Services in the Internal Market and Amending Directive 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC". COM(2013) 547 final". July 24, 2013. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0547:FIN:EN:PDF

The cornerstone of the draft legislation involves caps on the "multilateral interchange fees" ("MIF") that banks that service merchants pay to banks that service consumers when consumers use their cards to pay at merchants. These caps apply to banks that are members of the four-party bank-card networks.[5] The fee caps will reduce the revenue that cardholders' banks receive from merchants' banks by as much as 84 percent for debit and 73 percent for credit in some European countries. That is an experiment that several countries around the world have already performed with widely reported disastrous results for cardholders. When the merchant-side pays less the consumer-side pays more. Consumer fees go up, or services go down, and by far more than consumers may ever see back in lower prices from merchants.

It is even worse than that. By making every four-party bank network, in every country in Europe, have exactly the same MIF for every transaction regardless of the amount or type of merchant or any other factor, the legislation limits the ability of these four-party networks to compete through price and product differentiation. Perversely, given the claimed purpose of the legislation, this approach will soften competition between MasterCard and Visa. That will exacerbate the harm to European consumers through less choice, higher prices, and less innovation.

The defects of the legislation are most apparent in the treatment of the smaller card systems that operate primarily as standalone companies and do not involve large networks of banks. These companies, which are called "three-party systems," account for less than 5 percent of debit, credit and charge card volume in the EU. Their presence is known to be modest—less than 10 percent in virtually all EU Member States. Yet the legislation sweeps them into regulations that were originally motivated by competition concerns about the large four-party bank networks.

According to the legislation, if one of these standalone card companies decides to collaborate with even one bank to issue or acquire cards, the company may have to make its card brand available for all banks, in every country in the EU, to issue and acquire as well.[6] That requirement may lead these three-party systems to withdraw from a number of the smaller European markets where they have entered and extended their reach and coverage through perfectly legitimate individually and confidentially negotiated vertical agreements with a bank or payment institution partner. It may therefore perversely reverse the competitive entry that has taken place over the last two decades—entry that was enabled by a competition law-based intervention brought by the European Commission against Visa in the mid-1990s. It also deters

[5] The "three" in three-party systems refers to the cardholder, the card company, and the merchant. The "four" in four-party systems refers to the cardholder; the cardholder's bank; the merchant's bank, and the merchant. Of course, that list doesn't include the network operator, which would make five, but since this is the normal nomenclature I will use it. The network operator for the four-party system and the card company for the three-party system serve very different roles. The card company for the three-party system has direct relationships with cardholders and merchants. The network operator for the four-party system does not have direct relationships with cardholders and merchants.

[6] Article 29(1) of the proposed revised Payment Service Directive purports to extend the open access obligation for four-systems to three-party systems, requiring them to establish criteria for participation in the system by unrelated institutions which are objective, non-discriminatory and proportionate and do not inhibit access more than is necessary to safeguard against specified risks. The Commission's proposal on this issue has been endorsed by the European Parliament.

three-party systems, such as Cetelem in France, from considering a business model that involves partnerships and thereby arbitrarily limits the ability of these domestic three-party systems from expanding beyond their borders.

The legislation proposed by the European Parliament[7] also prohibits merchants from imposing added fees ("surcharges") on consumers who use cards from the four-party bank networks that account the preponderance of card use. It then, in a peculiar twist, specifically permits merchants to impose added fees on consumers who use cards issued by the smaller companies that compete with these large bank networks. This makes no sense at all. The ostensible rationale for the legislation is to provide tools to merchants in circumstances where they have to accept the cards issued by the "must have" four-party bank networks. That reasoning doesn't extend to smaller systems whose cards are not "must have" but, in fact, are "don't have" at many merchants.

The legislation proposed by the European Commission and European Parliament provides for extending price regulation to the smaller three-party systems. The price caps would appear to apply whenever these standalone card companies enter into an individually negotiated vertical agreement with an arm's length partner. In that case the proposals suggest that the three-party systems should be treated "as if they are a four party scheme."[8] It is unclear what these provisions mean in practice since these systems do not have a MIF that could be subject to a cap.

The proposed regulations on smaller players are inconsistent with sound competition policy, which imposes special obligations only on firms that are dominant in a market, and demands open access only in the extreme case of essential facilities such as telecom monopolies. Indeed, one sees how absurd the proposed legislation is from the effect of the combination of the proposed regulations on the smaller card companies. Several of the regulations make it harder for

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[7] See Article 55, paragraphs 3-4 European Commission, "Proposal for a Directive of the European Parliament and of the Council on Payment Services in the Internal Market and Amending Directive 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC". COM(2013) 547 final". July 24, 2013. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0547:FIN:EN:PDF. See also Amendments 111 and 112, European Parliament, "Amendments adopted by the European Parliament on 3 April 2014 on the proposal for a directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC (COM(2013)0547 – C7-0230/2013 – 2013/0264(COD))". April 3, 2014. Available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2014-0280+0+DOC+XML+V0//EN.

[8] See Article 1, paragraph 3 (c), Article 2 (15) and Articles 3-5, European Commission, "Proposal for a Regulation of the European Parliament and of the Council on Interchange Fees for Card-Based Payment Transactions". COM(2013) 550 final. July 24, 2013. Available at: http://www.ipex.eu/IPEXL-WEB/dossier/document/COM20130550.do. See also Amendment 21, Amendment 28, and Amendments 29-34, European Parliament, "Amendments adopted by the European Parliament on 3 April 2014 on the proposal for a regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions (COM(2013)0550 - C7-0241/2013 - 2013/0265(COD))". April 3, 2014. Available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2014-0279+0+DOC+XML+V0//EN.

these companies to compete against the likes of MasterCard and Visa, and risk undermining the competitive entry that the European Commission has previously sought to enable.[9]

The proposed payments legislation left behind by the outgoing European Commission and European Parliament is anti-consumer and anti-competition. The European Council should not approve it in its current form.

II. THE COMPETITIVE LANDSCAPE FOR PAYMENT CARDS IN THE EUROPEAN UNION

Networks of banks issue most debit, credit, and charge cards in the European Union. They are part of "four-party" systems in which one bank handles card payments for merchants, another bank handles card payments for cardholders, and the network company that operates the system has no direct relationship with either the merchants or the cardholders, but takes care of authorizing and clearing transactions between these banks, who are paid a common fee, the MIF, set by the network. In some countries such as the United Kingdom, most banks belong to networks operated by one of the global card networks—MasterCard and Visa.[10] In other countries, many banks belong to independent domestic networks—such as ServiRed in Spain and Cartes Bancaires in France. The domestic networks are often affiliated with MasterCard and Visa so their cardholders can use their cards in other countries using the global networks. Four-party systems almost always have a MIF that is adhered to by default and which the bank that issues the card receives from the bank that services the merchant.

Three-party systems also issue debit, credit, and charge cards in the EU. They typically sign up merchants directly and take care of reimbursing them for payments made on cards they issue; they also sign up and service consumers directly. Because they are single integrated enterprises they do not have interchange fees. In some countries the multinational three-party systems, American Express and Diners Club, work with a local partner that issues cards and in some cases may also work with merchants. Nonetheless, even in such circumstances, they continue not to have multilateral or bilateral interchange fees. As with any freely and bilaterally negotiated agreement, the two parties agree on how to allocate the revenues from their joint activities.

To understand the competitive landscape for payment card systems I have examined industry data for EU Member States that account for approximately 92 percent of EU GDP and 91 percent of EU population. The multi-national four-party networks account for more than 80 percent of debit, credit and charge card spend in most these countries and their average share, weighted by GDP, is almost 60 percent.[11] By contrast the multi-national three-party systems, in

[9] See discussion below and footnote 29.

[10] Visa International is a publicly traded global card system. Visa Europe is an association of European banks which are affiliated with Visa International and have entered into a deal in which they have the option of selling Visa Europe in return for equity in Visa International.

[11] The European Commission has claimed that credit, charge and debit cards are a separate relevant antitrust market and that they do not compete with cash, checks, or other means of payments. EC. Mastercard. COMP/34.579. December 19, 2007. Available at: http://ec.europa.eu/competition/antitrust/cases/dec_docs/34579/34579_1889_2.pdf. That definition is not consistent with the fact that payment card systems compete aggressively with these other forms of payments, such as cash, and that consumers and merchants can and do substitute readily between different forms of payment. Nevertheless, for

total, account for less than 10 percent of card spend in virtually every country and their average share, weighted by GDP, is about 3 percent. Visa and MasterCard dominate the payment card landscape in the EU.

As mentioned earlier, the multi-national three-party systems sometimes partner with banks or payment institutions in particular countries. Table 1 shows the extent of these partnership relationships for American Express for all EU countries. American Express operates directly in 11 EU Member States. It has partners in 17 Member States. It is apparent that American Express typically operates on its own in the larger economies but chooses to partner with banks in the smaller economies. The average GDP per capita of countries in which it operates on its own is € 37,359 while the average GDP per capita in countries for which it has a partner is, at € 15,889, more than 57 percent lower.

The main increase in competition occurred after 1996 when American Express began entering into bank partnerships to issue cards for use in various countries. That happened following a competition law-based intervention by the European Commission that challenged the introduction of a Visa rule that prohibited its member banks from issuing cards for a competitor other than MasterCard. These partnership relationships were mainly entered into over the course of the first decade of the century and reflect entry into these countries over that time period.

III. THE FAILED QUEST FOR A NEW PAN-EUROPEAN CARD SYSTEM

The European Commission has encouraged the creation of a pan-European system that could obtain a global presence. The Commission saw China's UnionPay as an example. The Chinese government established UnionPay as the card network for banks in China in March 2002.[12] China UnionPay cards accounted for over 9 billion card transactions in 2012.[13] Although the UnionPay cards are primarily issued to Chinese nationals, the cards are accepted in 141 countries and regions outside of China.[14]

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the purpose of this paper I use the Commission's view as a reference point, as this underlies the proposed legislation, that credit, charge and debit cards are together the relevant "market".

[12] China UnionPay, "Overview". http://en.unionpay.com/comInstr/aboutUs/file_4912292.html.

[13] The Nilson Report, #1043.

[14] China UnionPay, "Overview". http://en.unionpay.com/comInstr/aboutUs/file_4912292.html.

Table 1: American Express Entities and Partners in Europe

Country	Entities
Austria	American Express
Belgium	Alpha Card (American Express / BNP Paribas Fortis JV)
Bulgaria	Eurobank EFG Bulgaria
Croatia	PBZ Card
Cyprus	Bank of Cyprus
Czech Republic	Global Payments Europe
Denmark	Teller
Estonia	Swedbank
Finland	American Express
France	American Express, Credipar, Credit Mutuel
Germany	American Express
Greece	Alpha Bank
Hungary	OTP Bank
Ireland	Elavon Merchant Services
Italy	American Express
Latvia	Citadele Banka
Lithuania	Citadele Bankas
Luxembourg	Alpha Card (American Express / BNP Paribas Fortis JV)
Malta	Bank of Valletta
Netherlands	American Express
Poland	Bank Millennium, First Data
Portugal	Millennium bcp, Banco Espirito Santo
Romania	Bancpost / EFG Retail Services
Slovakia	VUB Bank
Slovenia	Banka Koper
Spain	American Express, Bansamex (American Express / Santander JV), La Caixa, Iberia Card, Banco Popular Espanol
Sweden	American Express, Entercard
United Kingdom	**American Express, BarclayCard, Lloyds Banking Group, TSB Bank plc, MBNA (Bank of America Europe Card Services)**

Another way to look at the situation in Europe is to consider several other large countries. The United States, China, Japan, and Russia all have large payment systems with roots in those countries.[15] These U.S., China, and Japan systems have secured worldwide distributions for their domestic card systems.

Several bank groups considered starting pan-European systems in the late 2000s. These included the European Alliance of Payment Schemes (EAPS), the Monnet Project, and payFair. The experience of the Monnet Project is instructive. The idea for starting a new pan-EU card system came about around 2008. A number of banks met in Madrid in 2010 to discuss the initiative and made plans for moving it forward. By 2011 the Monnet Project had developed detailed technical and business plans for starting a pan-European system. By then it included 24 banks drawn from seven countries including the EU-5 as well as Belgium and Portugal.[16] One of their key plans was to develop a mobile payments system for Europe.

The proponents of the new system, however, did not believe they could develop a viable business model that did not include economically meaningful interchange fees for the participating banks.[17] They took their concerns to the European Commission. The Commission, however, apparently would not entertain any system, including a new entrant, having interchange fees in excess of the low levels that the Commission was pursuing. Absent a clear revenue stream for issuing banks, the Monnet Project believed it could not move forward. It disbanded in April 2012 "owing", as the European Central Bank put it, "to the perceived absence of a viable business model."[18]

Meanwhile EAPS and payFair have not obtained much traction in Europe. EAPS is a coalition of the domestic independent card systems in Europe. According to the European Central Bank the number of participating systems has declined from six to three.[19] EAPS' webpage lists Consorzio BANCOMAT, EUFISERV, and the German Banking Industry Committee. However, their webpage provides no information on commercial activity after 2012. The latest news section on the site has only one item from April 2012. PayFair was started in 2007 by industry professionals and has attempted to develop a pan-European payment system. It highlights on its web site that it did its one-millionth transaction in 2013. Unfortunately, one

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[15] Visa and Mastercard in the United States, UnionPay in China, JCB in Japan, and several domestic systems in Russia. BIS (2011) "Payment, Clearing and Settlement Systems in Russia". CPSS – Red Book – 2011. Available at: http://www.bis.org/publ/cpss97_ru.pdf; BIS (2003) "Payment Systems in the United States". CPSS – Red Book – 2003. Available at: http://www.bis.org/cpss/paysys/UnitedStatesComp.pdf; BIS (2012) "Payment, Clearing and Settlement Systems in China"- CPSS – Red Book – 2012. Available at: http://www.bis.org/publ/cpss105_cn.pdf; Bank of Japan (2003) "Payment System in Japan". CPSS – Red Book – 2003. Available at: https://www.boj.or.jp/en/paym/outline/pay_boj/pss0305a.pdf.

[16] "EU Banks Ready to Break Visa/MasterCard Duopoly", *FinExtra.* June 15, 2011 http://www.finextra.com/news/fullstory.aspx?NewsItemID=22662.

[17] "EU Banks Ready to Break Visa/MasterCard Duopoly", *FinExtra.* June 15, 2011 http://www.finextra.com/news/fullstory.aspx?NewsItemID=22662.

[18] "Thumbs Down for Monnet", *PaySys SEPA Newsletter,* May 2012. http://www.paysys.de/download/SepaMay12.pdf.

[19] European Central Bank, "Card Payments in Europe – A Renewed Focus on SEPA for Cards," at p. 32. Available at http://www.ecb.europa.eu/pub/pdf/other/cardpaymineu_renfoconsepaforcards201404en.pdf.

million transactions, in total, over six years, is not an impressive number.[20] There were, for example, more than 1.2 billion transactions in Belgium in just one year, 2013.

Faced with the obstacles set in place by the European Commission there is, at this point, no significant effort underway, to my knowledge, to create a pan-European system.[21] Despite the prospect of legislation that claims to "nurture" competition in Europe it does not appear that anyone is waiting in the wings anxious to make another attempt to start a pan-European system. These facts strongly suggest that the legislation is not the solution but rather the problem along with the regulatory barriers to entry erected by the European Commission.

IV. OVERVIEW OF THE PAYMENTS LEGISLATION ENDORSED BY THE EUROPEAN PARLIAMENT

The legislation endorsed by the European Parliament in April 2014 shifts most of the cost of running domestic payment systems in Europe from merchants to consumers and favors MasterCard and Visa at the expense of domestic systems and smaller multinational competitors.

A. The Proposed Interchange Fee Regulations

The interchange fee is paid by the merchant's bank to the cardholder's bank in the four-party model. Typically the merchant's bank passes on most of the cost of the interchange fee payments to the merchant and the cardholder's bank passes on most of the benefit of the interchange fee revenue to the consumer in the form of lower fees and product enhancements. As a result the MIF balances how much one group of customers (merchants that accept cards) pays relative to another group of customers (cardholders). Increasing the interchange fee usually lowers what consumers pay for using cards and increases what merchants pay for using cards. In some cases, the two individual banks, one an acquirer for merchants and the other an issuer to cardholders, negotiate a bilateral interchange fee. Such bilateral negotiations are seldom practical for four-party bank networks with many participants that have to deal with each other. As a result, four-party bank networks typically set a default interchange fee that applies whenever there is no alternative bilaterally agreed fee. Notably, European competition authorities have never questioned interchange fees that are negotiated bilaterally between banks. Three-party systems, as noted earlier, do not have interchange fees.

Four-party systems use the interchange fee to compete with each other and with the companies that operate the so-called three-party system. A higher interchange fee helps attract banks to the system. And since banks pass savings on to cardholders the higher interchange fee also attracts cardholders, which in turn is critical to ensuring merchants are interested in accepting the network's cards. Card systems also have to consider the impact on merchant

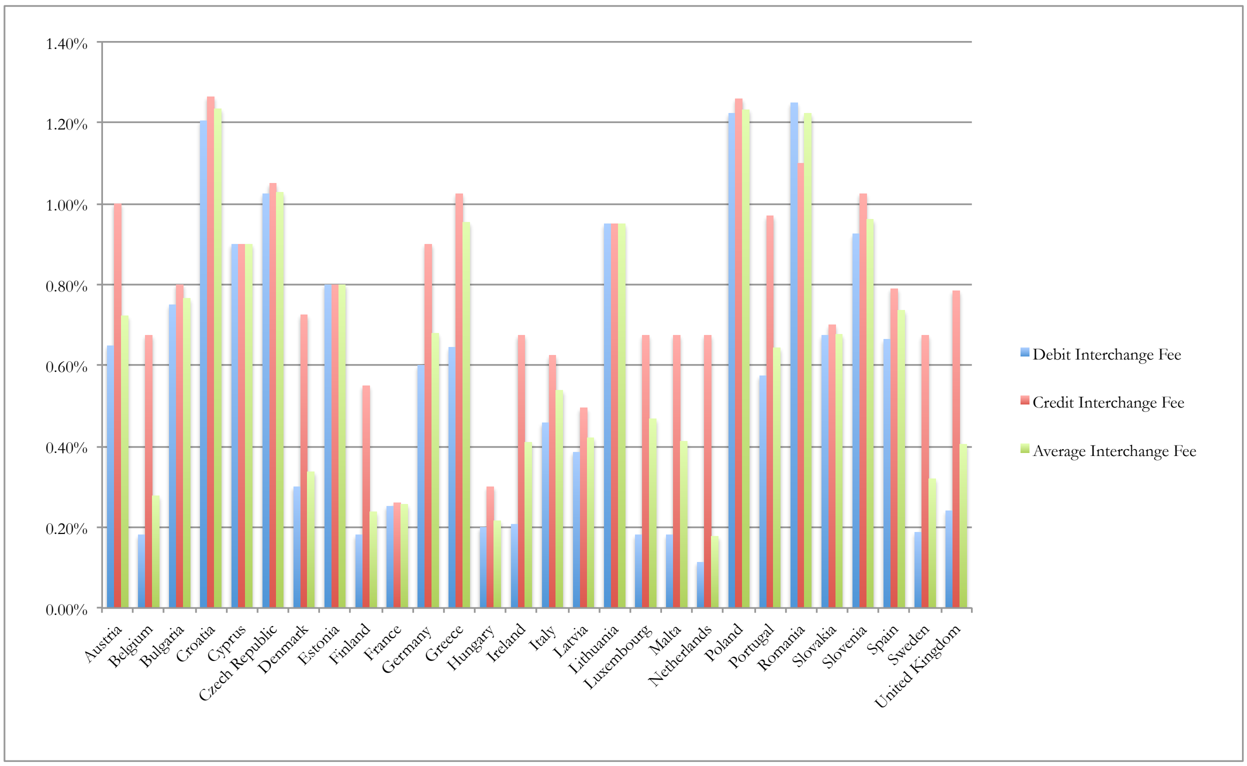
[20] The European Central Bank also mentions EUFISERV as one of the entities trying to establish a pan-European system. I note that their webpage has a 2012 date on it. Suffice it to say that it does not have much presence in Europe. http://www.eufiserv.com/home.aspx. Note that EUFISERV is also a member of PayFair.

[21] One possibility concerns the banks that belong to Visa Europe. Visa Europe is not owned by Visa. However, under the terms of an agreement Visa Europe has an option to sell itself to Visa International. There have been some discussions that Visa Europe would exercise that option after which the banks that belong to Visa Europe would establish their own pan-European debit card system. "Visa Likely to Purchase Europe Payments System", *Banking Services Payments",* March 20, 2013. http://payments.banking-business-review.com/news/visa-likely-to-purchase-europe-payments-system-200313.

acceptance. Acquiring banks may pass on some, or all, of the interchange fee to merchants, so a higher interchange fee results in a higher merchant fee. The companies that operate three-party systems also charge merchant fees, but do not have interchange fees. Four and three-party systems strike different balances between the prices to merchants and consumers. That is consistent with normal competition where businesses differentiate themselves based on price and many other features.

Four-party bank card systems also reach different judgments on the interchange fee, along with other prices, across EU Member States. That's not surprising. As much as Europeans might aspire for more similarity across countries, the countries differ enormously from one another in so many ways—from income levels, to the role of large merchants, to cultural preferences concerning credit. In fact, given the obvious differences it would be astonishing if the rate structures for cards were the same across Europe. Figure 1 shows the median interchange fees for credit and debit—taken at the EMV rate when available—for most of the EU countries.[22]

Figure 1: Interchange Fees in EU Countries



Source: See Appendix.

There is even more variability than shown in the figure. Four-party bank card schemes typically set different interchange fees for different kinds of payment cards. There are other

[22] See the appendix for details. To show interchange fees on a comparable basis we used the interchange fees for non-premium consumer cards used in face-to-face transactions.

differences as well. Rates for chip-and-pin cards used at the brick-and-mortar locations where the consumer is present when they are paying with the card are, for example, lower than the rates for online transactions. Rates can also vary by industry so in some cases rates for petrol are lower than for retail. These variations in the interchange fees are another source of competitive differentiation among the systems.

The Commission's proposals, broadly endorsed by the European Parliament, impose caps on the MIF adopted by four-party networks of 0.20 percent of the transaction amount for debit cards and 0.30 percent of the transaction amount for credit cards. For a € 50 payment the issuing bank would receive 10 eurocents for debit and 15 eurocents for credit. The same interchange fee caps would apply in every country, to every industry, for every merchant, online and offline, and for every size and type of transaction. The Commission has not, to my knowledge, provided any serious economic support for the level of these proposed caps, which are apparently wholly arbitrary. The interchange fee is the only method available for four-party systems to balance their relative prices to merchants and consumers since different banks serve these two sets of customers. Therefore the interchange fee caps prevent the card systems from differentiating themselves based on their relative prices to merchants and cardholders. Under the cap, none of the systems would be able to use interchange fees to attract banks from other systems.

The interchange fee caps would lead to a dramatic reduction in the fees collected by issuing banks in most EU countries. Table 2 shows the impact of the legislation by country. It shows the percent reduction in interchange fee revenue received by issuing banks. The figures are based on the average interchange fee for debit and credit cards for each country weighted by the volume of transactions for debit and cards.[23] The median reduction in fees is 66 percent. The reductions range from a low of 0 percent in Hungary to a high of 82 percent in Romania. They exceed 65 percent in 15 of the 28 Member States. In a few pages I'll show what these reductions mean for European consumers.

B. The Proposed Regulation of Three-Party Systems

The European Parliament's proposals prohibit merchants from imposing surcharges when consumers present a card from a four-party card system. At the same time it specifically allows merchants to impose surcharges when consumers present a card from a company that operates a three-party system. The law today, as set out in the Payment Services Directive, allows merchants to surcharge but gives Member States the option of banning merchant surcharging. As of February

2013, 14 EU countries had done that.[24] The new proposals do not allow EU Member States to opt out. Therefore under the European Parliament's proposals, merchants would be able to surcharge three-party systems throughout the European Union.

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[23] See Appendix.

[24] They are Austria, Bulgaria, Cyprus, Czech Republic, France, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, Portugal, Romania, and Sweden. See: London Economics, iff, and PaySys (2013), "Study on the Impact of Directive 2007/64/EC on Payment Services in the Internal Market and on the Application of Regulation (EC) No 924/2009 on Cross-Border Payments in the Community" (Table 17, page 70). Available at http://ec.europa.eu/internal_market/payments/docs/framework/130724_study-impact-psd_en.pdf.

Table 2: Reduction in Interchange Fees by Country

Country	Reduction in Debit Card Interchange	Reduction in Credit Card Interchange	Reduction in Overall Interchange
Austria	69%	70%	69%
Belgium	0%	56%	11%
Bulgaria	**73%**	**63%**	**70%**
Croatia	83%	76%	80%
Cyprus	78%	67%	73%
Czech Republic	80%	71%	79%
Denmark	33%	59%	36%
Estonia	75%	63%	73%
Finland	0%	45%	7%
France	21%	0%	10%
Germany	67%	67%	67%
Greece	69%	71%	70%
Hungary	0%	0%	0%
Ireland	4%	56%	26%
Italy	56%	52%	55%
Latvia	48%	39%	45%
Lithuania	79%	68%	77%
Luxembourg	0%	56%	32%
Malta	0%	56%	26%
Netherlands	0%	56%	6%
Poland	84%	76%	82%
Portugal	65%	69%	66%
Romania	84%	73%	82%
Slovakia	70%	57%	69%
Slovenia	78%	71%	76%
Spain	70%	62%	67%
Sweden	0%	56%	15%
United Kingdom	17%	62%	31%
Median	66%	62%	66%

Source: Based on our calculations; see appendix for details on the calculation of rates.

There is now extensive data and research on the results of surcharging.[25] We know from the experience of countries in Europe, and elsewhere, that most merchants do not surcharge when given the opportunity to do so. Some, however, use the ability to surcharge to act opportunistically towards consumers and exploit them. Depending on the interpretation, the proposed legislation also allows merchants that have agreed to accept cards from a three-party system to selectively refuse to take some of the system's cards for payment.[26] For example, a merchant could potentially choose to accept an American Express corporate card but not take the classic green consumer card product. When any merchant does that it creates uncertainty for consumers on whether other merchants will do the same.

In the eyes of consumers the regulations make the cards of three-party systems less desirable. Consumers may see signs at merchants alerting customers that they will surcharge certain three-party system cards. And consumers that have these cards will occasionally face opportunistic surcharging. The proposed legislation therefore seeks to incite the merchant community to participate in what would become a massive advertising campaign against the three-party card companies. Consumers will learn in no uncertain terms that if they want to be confident that they can use their cards to pay and be safe from opportunistic merchant behavior they should stick to MasterCard and Visa. The proposed legislation will taint the smaller three-party systems, which have been the main source of new competition in many countries, with a badge of inferiority and will create a two-tier structure of card products in which the three-party cards are inherently open to and most likely to be subject to unfavorable treatment.

The legislation also appears to impose open-access regulation on these three-party systems. To understand the implications of this requirement a short digression into the modern business model of these three-party systems is helpful.

Some of the standalone card companies have decided to enter into selective partnerships with banks to help expand their businesses.[27] This strategy helps them secure scale economies and network effects by issuing more cards and acquiring transactions in countries where they

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[25] See, for example, European Commission (2001), "Commission Decision of 9 August 2001 Relating to a Proceeding Under Article 81 of the EC Treaty and Article 53 of the EEA Agreement," Case No. COMP/29.373 (Visa International), 2001 O.J. (L 293) 24. Available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32001D0782&from=EN. European Commission (2006), "Interim Report I Payment Cards: Sector Inquiry Under Article 17 Regulation 1/2003 on Retail Banking." Available at http://ec.europa.eu/competition/sectors/financial_services/inquiries/interim_report_1.pdf. London Economics, iff, and PaySys (2013), "Study on the Impact of Directive 2007/64/EC on Payment Services in the Internal Market and on the Application of Regulation (EC) No 924/2009 on Cross-Border Payments in the Community." Available at http://ec.europa.eu/internal_market/payments/docs/framework/130724_study-impact-psd_en.pdf. Reserve Bank of Australia (2007), "Reform of Australia's Payments System: Issues for the 2007/08 Review." Available at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-issues.pdf. Reserve Bank of Australia (2011), "Review of Card Surcharging: A Consultation Document." Available at http://www.rba.gov.au/publications/consultations/201106-review-card-surcharging/pdf/201106-review-card-surcharging.pdf. Reserve Bank of Australia (2012), "A Variation to the Surcharging Standards: Final Reforms and Regulation Impact Statement." Available at http://www.rba.gov.au/payments-system/reforms/cards/201206-var-surcharging-stnds-fin-ref-ris/pdf/201206-var-surcharging-stnds-fin-ref-ris.pdf.

[26] See Article 10, proposed MIF Regulation.

[27] Visa used to prohibit its member banks from entering into these partnerships. Antitrust action taken by the European Commission forced it to allow these partnerships.

might otherwise have no presence, and thereby makes them stronger competitors to the large four-party systems in those countries and globally. Partnerships also enable three-party systems to enter countries without making significant investments and thereby reduce barriers to entry into the payments sector of these countries. American Express used this strategy starting in the late 1990s to enter 17 EU countries, mainly less wealthy ones as mentioned above, through partnerships with financial institutions. Diners Club also has bank partners in 8 countries that it has developed over the last several decades.

The European Commission and European Parliament proposals apparently require three-party systems to enter into partnerships on the basis of objective, proportionate and non-discriminatory criteria with ***any and all*** banks or payment institutions that want to issue or acquire cards for three-party systems if those systems make a deal with a single bank or payment institution in the EU. That requirement increases entry barriers for three-party systems into domestic payment markets because a decision to enter into a bank partnership triggers a requirement to provide access to banks throughout the EU as a result. As a practical matter the proposed legislation appears to subject the small three-party systems to "essential-facility" regulation that is commonly applied to domestic monopolies in energy, ports, and telecom. Such an approach imposes entirely disproportionate burdens and has no basis in competition or regulatory policy.

Finally, the proposed legislation appears to subject the three-party systems to price caps as well. Whenever the three-party system enters into a licensing deal to issue a card, it appears the system would be subject to the MIF price caps developed for and applied to four-party systems. It is unclear how the proposed legislation envisions this provision would apply in practice. The three-party systems do not establish an interchange fee that flows from an acquiring bank to an issuing bank. They do enter into a bilateral negotiation with a potential partner—which may have its own valuable brand and other assets in a particular country—over the allocation of revenues resulting from their joint activities. The viability of these confidential and bilateral negotiations appears under threat.

Beyond the issue of practicality is the question of what the possible justification for the price caps could be. The European Commission and other competition authorities that have challenged interchange fees for four-party systems have claimed that these fees violate the competition laws because they are set collectively and have also pointed to the dominant position of these four-party systems in a claimed market for debit, credit, and charge cards. To my knowledge, no competition authority, regulatory authority, or court has complained about commercial terms that are agreed bilaterally and it is hard to see under what basis these authorities could do so. Likewise, no competition authority, regulatory authority, or court, at least to my knowledge, has found that the merchant fees agreed between merchants and three-party systems are anticompetitive. Given the small European wide share that three-party systems have, in total, of debit, credit and charge card volume (the market identified by the European Commission) none of these systems is even remotely dominant.[28]

[28] The proposed legislation involving MIFs exposes three-party systems to other risks. In the text proposed by the European Parliament, the entire set of interchange fees regulations for four-party systems can be applied to three-party systems that exceed a threshold set by the European Commission. In practice, it is difficult to envision

The rationale for capping interchange fees does not apply to the financial terms that three-party systems negotiate with a licensee that issues cards. Interchange fees are direct payments from the merchant's acquirer to the cardholder's issuer and are typically passed on by the acquirer to the merchant. Competition and regulatory authorities have sought to reduce the impact of interchange fees on merchants and have done so by capping those fees. There is no pass through, however, between the fees that a three-party system negotiates individually with a licensee and the fees that the three-party system, or an acquiring partner, negotiates with merchants.

These proposed regulations of smaller three-party payment card systems are unprecedented outside the EU.[29] What is remarkable is the length to which the proposed legislation has gone to squelch competition by three-party card systems. The proposed legislation impairs the ability of these smaller systems to compete by permitting merchants to surcharge the smaller three-party systems but not the larger four-party ones and by making it costly for three-party systems to enter into select partnerships. But, then, just in case (against the odds) the three-party systems are successful, the proposed legislation empowers the European Commission to impose even more restraints if they surpass some undefined threshold.

V. IMPACT OF PROPOSED LEGISLATION ON COMPETITION IN THE EUROPEAN UNION

The proposed payments legislation has an Alice-in-Wonderland "up is down, left is right" flavor to it. In the name of "nurturing" competition the European Commission and European Parliament have come up with an approach that places an oppressive thumb on the smallest competitors, discourages the challengers, and weakens competition between the two giant systems left standing. Despite a vision of creating a European born-and-bred system the legislation pushes and shoves consumers to the dominant global brands. Then, in a final flourish, the legislation threatens the smaller systems with even more regulation if they are nonetheless able to continue providing a degree of increased competition. This is legislation that only Lewis Carroll could have written.

A. Restraining Three-Party System Competition

The proposed payments legislation restrains the ability of three-party systems to compete with the four-party card schemes, which are based on networks of banks, in at least three ways.

First, it imposes rules that make cards from the dominant four-party bank card systems "preferable"—in the sense of having fewer regulatory-imposed annoyances—for cardholders and merchants than cards from the smaller three-party systems. Consumers will learn that the three-party system cards are the ones that merchants can surcharge, possibly opportunistically, and reject altogether even though the merchant has a sign at their store claiming they accept the card.

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what this means. See Amendment 21, European Parliament, "Amendments adopted by the European Parliament on 3 April 2014 on the proposal for a regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions (COM(2013)0550 – C7-0241/2013 – 2013/0265(COD))". April 3, 2014. Available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2014-0279+0+DOC+XML+V0//EN.

[29] Spain recently adopted the Commission's proposals on this issue word-for-word, pending the adoption of final legislation (at which point Spain indicated it would be prepared to reverse course).

Consumers may find this out directly, from the media, or from friends, family and colleagues. It is easy to imagine the media reports advising consumers to stick with the major brands—MasterCard and Visa—to avoid having merchants subject them to a surcharge.

Second, the legislation could result in the three-party systems simply withdrawing as competitors in countries where they operate with a bank or payment institution partner. A single partnership agreement, anywhere in the European Union, exposes a three-party system to the risk that banks, including members of MasterCard and Visa, will insist on being able to issue or acquire the three-party system's cards as well. Under the legislation a three-party system that has entered a partnership with a single bank or payment institution, anywhere in the EU, may be required to offer the same terms to every other bank or payment institution that approaches the system. No longer could a three-party system decide to partner selectively and to do so in countries of its own choosing. It must either operate with no partners, or it must mimic the business model of the four-party bank associations and open itself up to all. The European Commission and the European Parliament have offered no credible explanation why three-party payment card schemes, that have miniscule shares in the market the European Commission has defined, should be subject to these requirements, nor have they considered apparently the consequence on competition of hobbling the smaller card rivals.

The legislation will make it harder for three-party systems to negotiate mutually profitable agreements with potential partners. A three-party system that enters into a deal with a bank or payment institution in a country may have to extend that deal to other banks or payment institutions in the country. Its chosen partner would find this unattractive for a variety of reasons. The prospective partner would effectively have to share the business opportunity of a smaller system with other banks and payment institutions, while still having to invest into the establishment and growth of that system, for the benefit of all comers. For example, any funds that the chosen bank or payment institution partner spends on marketing and advertising the brand would benefit other banks that insist on issuing the three-party system card as well. The legislation therefore undermines the investments of a three-party system's partner and thus makes it harder for three-party systems to reach acceptable partnership deals.

The legislation also makes it less profitable for a three-party system to enter into any partnership deal and thereby eliminates all the competition that results from these relationships. A three-party system that negotiates a partnership arrangement in a single country loses its ability to manage its system throughout the EU. It could be forced to partner unwillingly with banks or payment institutions in that country as noted above. In addition, however, it could be forced to partner with banks and payment institutions in countries in which it would prefer to operate alone and with banks that it would prefer not to work with at all.

The legislation therefore poses a serious risk that three-party systems that rely on partnership deals to extend their reach across the EU will either end these partnership deals because of the risks and costs they pose or that their partners will end these deals if the system cannot assure them of an exclusive deal in that country. That is an odd coda to the competition policy decision the European Commission took in 1996 when it forced Visa to allow its member banks to enter into selective partnerships with three-party systems.

Third, the payments legislation will retard future entry of three-party systems throughout the EU in addition to unraveling past entry. Existing three-party systems will likely refrain from considering entering countries in the EU through partnership deals. Consider Cetelem, which operates a standalone card system in France. Suppose that, as the single EU market evolves, Cetelem would like to enter some countries by forming a partnership with a bank or payment institution. As soon as it enters into one partnership in one country, it opens itself up to demands that it provide similar deals to banks and payment institutions in that country and every other EU country. That prospect would likely deter Cetelem from ever considering partnerships and therefore limit its ability to compete on a pan-European basis.

More importantly, the legislation makes the EU a very unwelcome area for entry by any new three-party system. Suppose, for example, that a three-party global mobile payments system emerges and that system needs to consider where to enter around the world. The EU will be the only place in the world in which merchants are allowed to surcharge, and reject, the cards of three-party systems but not of MasterCard or Visa. Suppose, as is common in mobile payments, the three-party system wanted to partner with a bank to enter the EU or a Member State. It could not guarantee its partner an exclusive deal and, if it entered into a relationship in any country, it would potentially have to extend that deal to all banks and payment institutions in that country and the other EU countries as well and be price capped when doing so.

B. Softening Four-Party System Competition

The European Parliament's payment legislation weakens competition among the four-party systems.

To begin with it softens competition between MasterCard and Visa. They won't be able to use the interchange fee to compete for issuers, consumers, or merchants. No longer would one of these companies be able to lower their interchanges fees for a particular type of merchant to secure acceptance, to increase their interchange fees to persuade banks to switch card volume to them, or to increase their interchange fees to promote benefits that could attract more cardholders.

Four-party systems have used selective reductions in interchange fees to promote new technologies such as chip-and-pin cards and contactless cards. They would lose that ability under the payments legislation: with such a substantial reduction in these fees it is unlikely they could persuade banks to accept an even lower fee. If one of the systems came up with a technology for accepting payment at the point of sale—for example related to mobile payments—it would lose one of its main tools for persuading merchants to invest in the necessary changes. MasterCard and Visa will of course continue to compete but will do so with one hand tied behind their backs.

The payments legislation weakens competition among the global four-party systems and the independent domestic systems for these same reasons. None of these systems will be able to agree to higher interchange fees to compete for banks and consumers. And, with the drastic reductions, few if any could risk bank defections if they wanted to lower interchange fees further to promote innovative technologies or business practices by the merchants.

The threat to domestic competition though is actually much worse. An independent domestic system could not offer banks a somewhat higher interchange fee to induce them to switch from the domestic MasterCard or Visa network. That eliminates an important competitive tool. Once the payments legislation makes all systems exactly the same when it comes to interchange fees the advantage of switching to a system that lacks the scale economies, brand recognition, and marketing prowess of MasterCard and Visa is lessened. The proposed legislation places the survival of the domestic systems at risk and it is conceivable that they will wither over time or simply become appendages of the global four-party networks.

Lastly, the very low interchange fee caps proposed by the European Parliament largely gut the business models of new four-party entrants. As I've noted this isn't mere conjecture. We have the dead body to prove it. A substantial viable pan-European entrant gave up when the European Commission wouldn't relent on its insistence that four-party systems have not only low interchange fees but interchange fees that can't be any higher for any country, industry, product, transaction type, or anything else.

C. The Anticompetitive Payments Legislation

The European Commission and the European Parliament have put forward legislation that is anti-competitive. It fixes the interchange fee that MasterCard and Visa use to compete with each other and independent domestic schemes. It places independent domestic schemes that would be less able to differentiate themselves at a disadvantage. After the Commission helped destroy a major pan-European entrant, the proposed legislation raises a barrier to further entry by any potential new payment systems. As a finishing touch it hobbles all of MasterCard and Visa's three-party system rivals.

Almost two decades ago, when Visa proposed rules to prohibit three-party systems from pursuing arm's length licensing agreements with banks that were members of Visa, the European Commission claimed competitive harm and acted swiftly to prevent it. It seems perverse now that the EU is at risk of delivering the same outcome for Visa and legitimizing the endeavor that it previously claimed was anticompetitive.[30]

VI. HOW THE EU PAYMENTS LEGISLATION WILL AFFECT CONSUMERS

The European consumer is ultimately the big loser from the proposed EU payments legislation.

Studies have found that consumers end up paying more in countries that have capped interchange fees.[31] This result is obvious. Competition forced banks to offer low fees (either on the cards themselves or the current account held by the consumers) when they were getting interchange fee revenues. When that revenue is reduced sharply banks have to increase fees (either on the cards themselves or on the current account held by the consumers).

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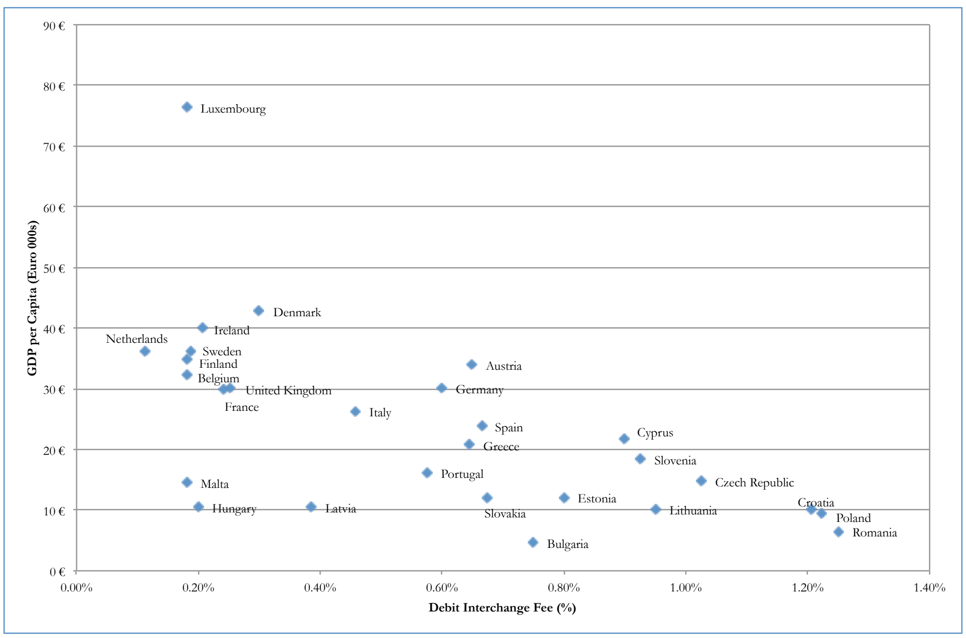
[30] As per the following press release the Commission's Directorate General for Competition reached the view that Visa's proposed rule prohibiting its member banks from partnering with American Express would have infringed the EC competition rules because it would have restricted competition between international cards systems as well as between banks which issue cards riding on those systems. Moreover, at the time, the Commission confirmed its determination to ensure that access to the payments card market by new competitors such as three-party schemes should not be impeded. http://europa.eu/rapid/press-release_IP-96-585_en.htm.

[31] Evans, David S. and Rosa Abrantes-Metz (2013) "The Economics and Regulation of the Portuguese Retail Payments System". Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2375151.

Defenders of interchange fee caps, in my experience, do not deny this relationship between interchange fees and consumer prices. Instead, they counter the well-documented fact that consumers pay banks more when interchange fees decline with the claim that merchants pass the entirety of their interchange fee cost savings back to consumers in the form of lower prices and that therefore consumers come out ahead when these lower merchant prices are considered.[32] They base this claim on pure speculation and provide no evidence that any merchant has passed any savings whatsoever on.

Their assertions are not supported by economic theory and are roundly rebutted by empirical evidence.[33] My study in the US, for example, found that merchants kept about half of the savings from debit card fee reduction for themselves and that consumers will end up losing more than $22 billion as a result of shifting the costs on to them.[34] Large retailers with revenues of hundreds of millions of dollars a year and market valuations north of $1 billion were the chief beneficiaries.

Figure 2: Average Debit Interchange Fees versus Per Capita GDP in EU Countries



Source: European Central Bank.

[32] Evans, David S., Howard Chang and Steven Joyce (2013) "The Impact of the U.S. Debit Card Interchange Fee Regulation on Consumer Welfare: An Event Study Analysis". Coase-Sandor Institute for Law and Economics Working Paper No. 658 (2D Series). Available at: http://www.law.uchicago.edu/files/file/658-dse-hj-sj-impact-fixed.pdf. Forthcoming, *Journal of Competition Law and Economics.*

[33] Evans, David S. and Abel M. Mateus (2011) "How Changes in Payment Card Interchange Fees Affect Consumers Fees and Merchant Prices: An Economic Analysis with Applications to the European Union". Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1878735.

[34] There is no serious dispute that merchants do not pass on 100 percent of the cost savings nor could there be given economic theory and empirical evidence. Notably, a study in the US estimated that merchants kept about a third of the interchange fee cost savings as profits. Shapiro, Robert J. (2013) "The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees". SONECON. Available at: https://nrf.com/sites/default/files/The_Costs_and_Benefits_of_Half_a_Loaf.pdf.

The extent of the redistribution from merchants to consumers varies enormously across countries. Consumers in high-interchange fee countries such as Romania will lose much more relatively speaking than consumers in low-interchange fee countries such as Denmark. Figure 2 shows the relationship between the average debit card interchange fee in each country and GDP per capita. The graph shows that the debit card interchange fee is higher in countries with lower per capita GDP. The countries that will have the largest reductions in interchange fees, and therefore the greatest harm to consumers, are the poorest countries; the countries that will have the lowest, and in some cases no, reductions in interchange fees and therefore the least harm to consumers are the richest countries. There are exceptions, of course, but that is the general rule. The interchange fee caps take from the consumer and give to the merchant, and they take the most from the poorest consumers. As I said, this is Alice-in-Wonderland public policy.

The EU payments legislation harms European consumers in other ways. Approximately € 88 billion was spent in 2012 by Europeans using cards from three-party systems in the Member States that account for more than 90 percent of GDP and population. Consumers will also face occasional opportunistic surcharging by merchants on such purchases. A consumer also risks having merchants that advertise that they accept a three-party system brand turn around and reject the particular card the consumer presents. In the longer run consumers are also likely to find that they have less choice than they have now as independent domestic card systems and three-party systems are forced to withdraw from the payment card market in countries across the EU. Consumers are also likely to have even less choice than they would get in the absence of the payments legislation. That's because the legislation will reduce entry into payments cards in the European Union.

VII. CONCLUSION

The European Commission's proposal and the common position reached by the European Parliament in April 2014 is ill-conceived and poorly thought through. This is no surprise, given how woefully inadequate—and in some areas, completely lacking—the impact assessment undertaken by the Commission is. The proposed legislation destines Europe to having a payment card industry operated largely by banks and run by two global brands. The prospect of low caps on interchange fees has already killed or chilled the prospects for the emergence of a new pan-European payment system. Those caps will temper competition between MasterCard and Visa and may drive independent domestic systems out of business altogether over time. The bizarre restraints on the three-party systems in European countries, all of them much smaller than their four-party rivals across Europe, will make these companies less vibrant competitors and may drive them out of many countries in Europe. For European consumers the proposed payments legislation would lead to a hefty price tag, diminished choice, and depressed innovation.

The European Council would be wise to discard this legislation as currently drafted. Any new legislation should completely abandon restraints on the three-party systems that are essentially fringe competitors in Europe. There is simply no sensible rationale for these restraints and none has been offered. New legislation should also drop the caps on interchange fees. These caps weaken competition between MasterCard, Visa, and independent domestic card systems. They also shift the costs of payment cards to consumers and will cost European consumers billions of euros in added fees.

APPENDIX

CALCULATION OF INTERCHANGE FEES BY COUNTRY

This appendix describes the calculation of interchange rates by country.

We started by obtaining Visa and MasterCard's current intra-country interchange fee schedules.[35] Visa and MasterCard typically have many different interchange rates that depend on the type of card used, how the transaction is processed, and the merchant's sector. Separately for credit and debit, for each country, for each system, and for each merchant sector, we limited attention to one interchange rate. In each case, we picked an interchange rate that applied to intra-country transactions that used non-premium consumer cards in a face-to-face transaction. For cases where there was a separate rate for EMV or Chip+PIN transactions, we used that rate. In countries without that distinction, we used the rate for electronically authorized transactions. There are interchange fee rates that are higher or lower but the rates we used were typically in the middle and reflect the most common type of transactions.

We then converted each interchange rate into a percentage of the transaction amount. In most cases the fees were already expressed in percentage terms, so this involved no additional calculations. In other cases, the interchange fees were expressed as a flat fee plus a percentage of the transaction amount. In these cases, we needed to make an assumption about the average transaction size. We used data from the European Central Bank for 2012 to calculate an EU-wide average transaction size for debit cards (€48.15) and credit cards (€67.82).[36] We used these average transaction sizes to calculate the average total interchange fee. For example, in Belgium, the interchange fee for Visa debit is 0.15% + €0.015. At an average transaction size of €48.15, this works out to (0.0015*48.15 + 0.015)/48.15 = 0.18%.

Next, for each country, system (Visa or MasterCard), and product (credit or debit), we calculated the median interchange rate across all merchant sectors. This gives us two debit interchange rates and two credit interchange rates for each country.

Next, we obtained estimates of interchange fees for the large domestic card systems. Table A summarizes the data.

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[35] Visa Europe, "Our Fees." Available at http://www.visaeurope.com/en/about_us/our_business/fees_and_interchange.aspx; MasterCard International, "MasterCard Intra-Country Interchange Fees." Available at http://www.mastercard.com/us/company/en/whatwedo/interchange/Country.html.

[36] European Central Bank, Statistical Data Warehouse. Available at http://sdw.ecb.europa.eu/reports.do?node=1000001431.

Table A: Interchange Fees for Large Domestic Card Systems

Country	System	Type	Interchange Fee (Actual)	Interchange Fee (%)
Denmark	Dankort	Debit	0.20%[37]	0.20%
France	Cartes Bancaires	Credit	0.28% + fraud adjustment averaging no greater than 0.03%[38]	0.31%
Germany	ZKE	Debit	0.30%[39]	0.30%
Italy	PagoBancomat	Debit	0.1309% + €0.10[40]	0.34%
Portugal	MB	Debit	0.50%[41]	0.50%
Spain	Servired	Credit	0.76%[42]	0.76%
Spain	Euro 6000	Credit	0.79%[43]	0.79%
Spain	4b	Credit	0.75%[44]	0.75%
Spain	Servired	Debit	€0.33[45]	0.69%
Spain	Euro 6000	Debit	€0.32[46]	0.66%
Spain	4b	Debit	€0.30[47]	0.62%

[37] Denmark's Dankort pays issuers a flat fee per transaction, where the level of the flat fee depends on the issuer's annual number of transactions. In general, this fee is less than 0.20 percent, although it may be higher on small-value transactions. Ministry of Growth and Business Denmark, "Interchange Fee Regulation and Domestic Debit Card Schemes," June 2, 2014. Available at http://www.eu-oplysningen.dk/upload/application/pdf/ca7ff3c0/201305502.pdf?download=1. The exact average interchange fee appears to be non-public.

[38] Cartes Bancaires, "Current CB Multilateral Interchange Fees and Tariffs." Available at http://www.cartes-bancaires.com/IMG/pdf/CB_Interchange_Fees_and_Tariffs.pdf; PaySys, "French Anti-Trust Authority Decision on MIF," PaySys SEPA Newsletter, June-July 2011. Available at http://www.paysys.de/download/SepaJunJul11.pdf.

[39] Der Handel, "Bundeskartellamt kippt Girocard-Gebühr," April 8, 2014. Available at https://www.derhandel.de/news/finanzen/pages/Bundeskartellamt-kippt-Girocard-Gebuehr-10503.html.

[40] Conzorzio Bancomat, "Commissioni Interbancarie." Available at http://www.bancomat.it/it/consorzio/commissioni.html.

[41] David S. Evans and Rosa Abrantes-Metz (2013), "The Economics and Regulation or the Portugese Retail Payments System." Available at http://www.sibs.pt/export/sites/sibs_fps/pt/documentos/The-Economics-and-Regulation-of-the-Portuguese-Retail-Payments-System_2013.pdf.

[42] Servired, "Tasas de Intercambio: Intra-Sistema." Available at http://www.servired.es/tasas-de-intercambio/intra-sistema/.

[43] Euro 6000, "Tasas de intercambio: Intra-Sistema." Available at http://www.euro6000.com/informacion-corporativa/tasas/intrasistema.

[44] 4B, "Tasas de intercambio." Available at http://www.4b.es/productos-y-servicios/comercios/tasas-de-intercambio.

[45] Servired, "Tasas de Intercambio: Intra-Sistema." Available at http://www.servired.es/tasas-de-intercambio/intra-sistema/.

[46] Euro 6000, "Tasas de intercambio: Intra-Sistema." Available at http://www.euro6000.com/informacion-corporativa/tasas/intrasistema.

[47] 4B, "Tasas de intercambio." Available at http://www.4b.es/productos-y-servicios/comercios/tasas-de-intercambio.

Cases with a flat interchange fee were converted to percentages of the transaction using the same method used for Visa and MasterCard.

Next, we calculated the median debit and credit interchange rate for each country, taking the median across all systems. Then we calculated an overall average interchange rate as a weighted average of the debit and credit interchange rates, using each product type's share of all payment card spending in the country as the weights. Data on the value of debit and credit card payments were taken from 2012 data from the European Central Bank.[48]

[48] European Central Bank, Statistical Data Warehouse. Available at http://sdw.ecb.europa.eu/reports.do?node=1000001431.

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Competition Policy in Selection Markets

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Competition Policy in Selection Markets

Neale Mahoney, André Veiga & Glen Weyl[1]

I. INTRODUCTION

One of the oldest arguments against both competition and the policies promoting it is the problem of cream-skimming. In *selection markets*, like insurance and finance, where some customers are cheaper to serve than others, competitors have an incentive to poach the most lucrative customers from their rivals, the "cream." As Rothschild & Stiglitz[2] and de Meza & Webb[3] famously showed, this form of competition often causes severe problems, as competing firms distort their product quality or price in order to attract the cream. Such concerns were a leading part of debates over public utility regulation and the antitrust defense of AT&T, as highlighted by Faulhaber,[4] and have been well known in economics since the work of Rothschild and Stiglitz. However cream-skimming has never made it into the models economists use to evaluate mergers and other competition policy issues.

This article reviews a pair of recent papers (Mahoney & Weyl[5]; Veiga & Weyl[6]) in which we have begun to fill this lacuna. In particular, we have found that in many realistic cases there can be too much competition in selection markets and that, even when this is not the case, many standard intuitions of competition policy are reversed by the presence of selection.

We define a selection market as one where some central feature of the product sold requires that purchasers have heterogeneous costs to the firm. For instance, insurance would not be insurance if it did not indemnify individuals against their future costs, but in doing so it makes unhealthy consumers more expensive to cover. Other examples of selection markets include:

1. Financial markets, where limited liability and risk-aversion may force the financier to share the benefits and costs of the financed project with the financed individual or firm.

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[2] Michael Rothschild & Joseph E. Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90(4) QUARTERLY J. ECON., 629-649 (1976).

[3] David de Meza & David C. Webb, *Too Much Investment: A Problem of Asymmetric Information*, 102(2) QUARTERLY J. ECON., 281-292 (1987).

[4] Gerald R. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65(5) AMER. ECON. REV., 966-977 (1975).

[5] Neale Mahoney & E. Glen Weyl, *Imperfect Competition in Selection Markets* (2014) *available online at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2372661.

[6] André Veiga & E. Glen Weyl, *Product Design in Selection Markets* (2014) *available online at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1935912.

2. Platform markets, like Facebook, where much of the value of the service is generated by its users, some of which are much more active or popular than others.
3. Customer markets, like many supply relationships, where suppliers form long-term relationships with customers and landing a loyal "big fish" can become a continuing source of profit.

While all these markets feature selection, the patterns of selection are quite different across them. Insurance markets often feature *adverse* selection, where those most eager to purchase the product are the least desirable customers. Conversely, financial markets often have *advantageous* selection: the riskiest customers are the least likely to apply for credit and are attracted only by the teaser rates and low down-payments that firms use to attract other, more profitable customers.

In this article we discuss the severe, but very different, problems created for competition policy in these two environments. To do so, we draw on calibrated models of sub-prime automobile lending and health insurance that we developed in related papers. We then turn to the implications of our analysis for practical competition policy.

II. ADVANTAGEOUS SELECTION AND EXCESS CREDIT

The 2008 financial crisis highlighted the large social costs of excessive consumer credit. As documented by Mian & Sufi[7], the pre-crisis period featured generous loan terms to subprime borrowers in the form of sharply reduced down-payment requirements and negligent verification of borrower income. This was followed by an increase in default rates and reduction in lender profit. This evidence is consistent with de Meza & Webb's[8] definition of advantageous selection: marginal borrowers, who are drawn to borrowing by the reduced down-payment and documentation requirements, are worse credit risks than the average borrower.[9]

As de Meza & Webb explain, advantageous selection leads competitive markets to supply too much credit. Competing lenders are eager to attract profitable inframarginal consumers from their competitors. However, they are unable to distinguish them from the less profitable marginal consumers. This forces them to offer more generous terms to all borrowers, attracting risky borrowers along with the cream. Yet from society's perspective these two effects are not balanced because, when a lender successfully poaches profitable borrowers, it imposes an externality on its competitors. A monopolistic lender would internalize these "cream-skimming" externalities but competitive firms do not, leading them to offer excessively generous borrowing terms. This suggests that policies such as the Gramm-Leach-Bliley Act, which intended to bring

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[7] Atif Mian & Amir Sufi, *The Consequences of Mortgage Credit Expansion,* 124(4) QUARTERLY J. ECON., 1449-1496 (2009).

[8] David de Meza & David C. Webb, *Too Much Investment: A Problem of Asymmetric Information*, 102(2) QUARTERLY J. ECON., 281-292 (1987).

[9] If, on the other hand, competition is primarily on interest rates rather than on down-payments, Stiglitz & Weiss argue selection may be adverse. We are not aware of any evidence confirming this theory in consumer credit markets and much of the competition over this period appears to have been on dimensions that seem likelier to lead to advantageous selection. This is confirmed by the data we calibrate to. However, obviously more research in this area would be very valuable. Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71(3) AMER. ECON. REV., 393-410 (1981).

"greater…competition in the financial services industry," could have contributed to an inefficient credit boom.[10]

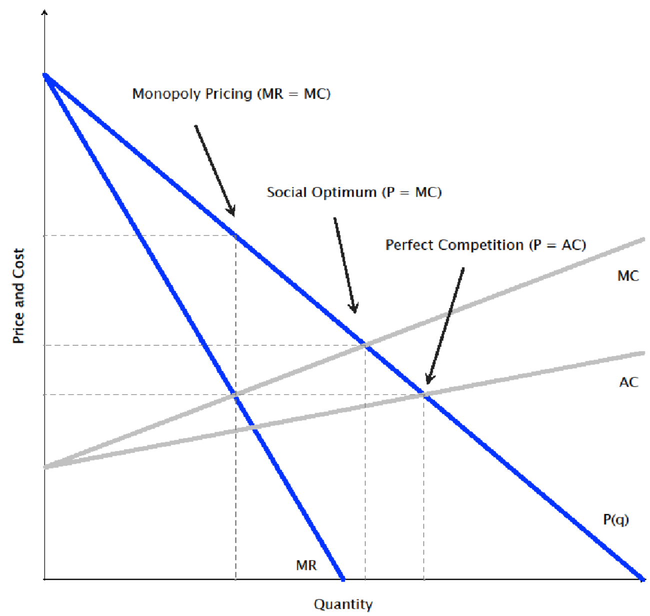

Figure 1: The distortions of perfect competition and monopoly under advantageous selection.

The economic logic behind this argument can be demonstrated in a simple graph. Consider the determinants of the equilibrium down-payment on a loan P, holding fixed the interest rate and total amount borrowed. Figure 1 plots inverse demand, average cost (AC) and marginal cost (MC) of supplying the loan as a function of the fraction of the population receiving a loan, q. AC and MC are upward-sloping under advantageous selection, since marginal borrowers are costlier than inframarginal borrowers. As is familiar, the socially optimal quantity of loans occurs when demand intersects marginal cost ($P = MC$). At the competitive equilibrium where firms earn zero profits ($P = AC$), there is more credit supplied than is socially optimal. Conversely, a monopolist would supply credit until marginal revenue equals marginal cost ($MR = MC$), which is less than the socially optimal amount.

The social optimum thus lies between perfect competition and monopoly. In fact, in Mahoney & Weyl,[11] we show that there is always an intermediate degree of market power that achieves the social optimum. An increase in market power is socially useful if there is excessive provision of credit, while an increase in competition is desirable if credit is under-supplied.

Is it plausible that excessive competition in the 2000s contributed to an inefficient credit boom? To investigate this question we drew on data from subprime auto lending studied by Einav, Jenkins, & Levin[12] (henceforth "EJL"). The setting is useful because quasi-randomization

[10] President Clinton's signing statement, November 12, 1999: http://www.presidency.ucsb.edu/ws/?pid=56922.

[11] Mahoney & Weyl, *supra* note 4.

[12] Liran Einav, Mark Jenkins, & Jonathan Levin, *Contract Pricing in Consumer Credit Markets,* 80(4) ECONOMETRICA, 1387-1432 (2012).

of contract terms allows for clean estimation of the underlying market parameters and because the borrowers in EJL's data are similar in many dimensions to subprime mortgage borrowers. EJL's calibrated model indicates extreme advantageous selection. For the modal contract, borrowers marginal with respect to a change in minimum down payment default 79 percent of the time, compared to only 59 percent among average borrowers.

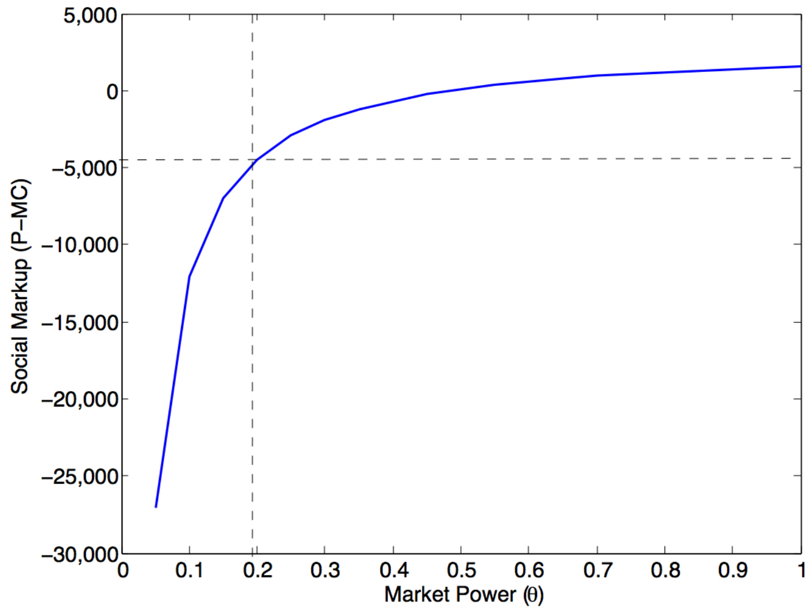

Figure 2: The social mark-up as a function of market power in a calibration of Mahoney & Weyl[13] to the EJL subprime auto loan data.

The net distortion from advantageous selection and market power can be summarized by the social markup for the marginal borrower, which is the gap between the price they pay and the average marginal cost of providing them a loan. Figure 2 plots this social markup (y-axis) as a function of a market power parameter θ (x-axis), where 0 represents perfect competition and 1 monopoly. The value $\theta = 0.2$ is a useful benchmark: with symmetric Cournot firms it corresponds to an Herfindahl-Hirschman Index of 2,000, just above the threshold the Department of Justice uses to define markets as highly concentrated.

The figure indicates that, in this case, the marginal borrower is subsidized by \$4,462 or 41 percent of the price of the car. The marginal borrower receives a subsidy whenever $\theta < 0.5$, which corresponds to a symmetric Cournot duopoly, indicating that higher levels of concentration may be desirable. While our analysis should be interpreted with caution, implicit subsidies of this magnitude could easily reverse standard prescriptions for competition policy and the design of pro-competitive financial deregulations that do not consider selection.

III. ADVERSE SELECTION AND STINGY INSURANCE

When selection is *adverse*, as is typical in health insurance markets, competition does not lead to oversupply, but the opposite. Marginal purchasers of health insurance are usually "young invincibles" who are cheap to cover. Infra-marginal purchasers are typically the elderly and sick,

[13] Mahoney & Weyl, *supra* note 4.

who are willing to pay more to have coverage. For insurers to break even in a perfectly competitive market, they must set premiums to cover the cost of the elderly and sick. Since these premiums are higher than the cost of serving the young invincibles, high premiums may drive many of them out of the market, an effect familiar from the debates over the Affordable Care Act (henceforth "ACA"). In this case, market power only makes matters worse as it allows firms to further raise prices.

However, these results change when one considers that employers choose to offer their employees not only the price of a single plan, but rather several price-quality combinations for several plans. To see why, imagine a version of the ACA health exchanges with just two plans: bronze and platinum, the lowest- and highest-quality plans available under the ACA. If almost all healthy people opt for bronze leaving the sick in platinum plans—as the logic of adverse selection suggests—the cost of platinum plans will become prohibitive because the sick are so expensive to cover. This would encourage insurers to drive the platinum plans out of the market by drastically increasing their prices, resulting in a collapsed market where only bronze plans are purchased.

However, this "death spiral" does not typically happen with employer-provided insurance. Why don't their young invincibles opt for catastrophic care while the old and sick choose comprehensive plans? The reason is that employers don't simply price each plan at the cost of providing it. They care about the stability of the firm's insurance system as a whole, so they steer the young and healthy toward more comprehensive plans. They do this by raising the price of bronze plans, thereby effectively cross-subsidizing platinum plans. This is simply an extension of the basic idea of insurance, applied across the plans of a particular employer: those who are less at risk subsidize others who are more so.

Much like an employer, an oligopoly with sufficient market power can stop the destructive adverse selection spiral by similarly adjusting prices on plans of different qualities. There is an incentive to do so because each oligopolist is concerned with the stability of the market overall: if the market collapses oligopolists obtain lower profits. Large insurers will thus raise the prices of bronze plans to steer some healthy individuals toward platinum, thereby improving market stability. However, this will not happen if several smaller insurers can destabilize the market by offering cheap bronze plans that poach the healthiest people from the large insurers. This could force even large insurers to restrict themselves to only a bronze plan, even though it is typically in the interest of large insurers to pursue a broader slice of the market. Only if many small insurers hold profits down does the bronze-only strategy pose a real threat.

To investigate the empirical relevance of this possibility, in Veiga & Weyl[14] we considered a simple model of insurance competition where each insurer can offer a single plan with premium P, covering a percentage x of a consumer's medical spending. For instance, a bronze plan is x =60 percent, while platinum is x =90 percent. We then used data that Handel, Hendel, & Whinston[15] collected from a large insurer to calibrate a model of demand. We studied the effect of market power on the (unique) equilibrium predicted by our solution concept. Market

[14] Veiga & Weyl, *supra* note 5.

[15] Benjamin R. Handel, Igal Hendel, & Michael D. Whinston, *Equilibria in Health Exchanges: Adverse Selection vs. Reclassification Risk (2014) available online at* http://emlab.berkeley.edu/~bhandel/wp/Exchanges_reclassification_HHW.pdf.

power was measured by considering the markup as a percentage of the average cost of providing the offered actuarial rate x.

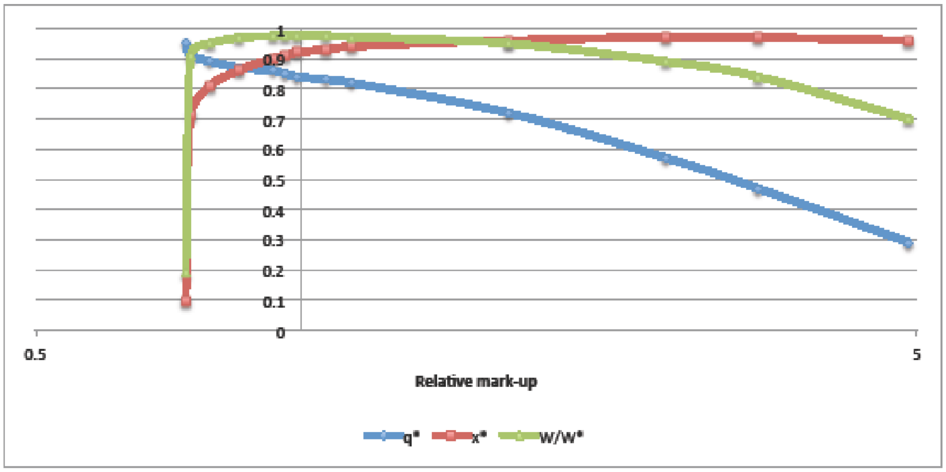

Figure 3: Population coverage, actuarial rate and welfare relative to the first best as a function of the relative mark-up (load) in the calibration of Veiga & Weyl[16] to the Handel, Hendel, & Whinston[17] data.

Figure 3 shows our results. As market power rises, firms raise prices and thus the fraction of individuals who obtain insurance ($q^\star$, shown in blue) declines. However, at the same time, the actuarial rate offered by the insurers ($x^\star$) rises rapidly. If markups are less than 74 percent of cost, no insurance is possible in equilibrium because the incentives to cream-skim are too severe. By contrast, with a load of 110 percent, 94 percent insurance is offered and 82 percent of the population purchases insurance. While this scenario is not ideal, it manages to achieve 98 percent of the welfare realized in the ideal setting of every individual obtaining full insurance, whereas perfect competition leads to complete market collapse. As load rises above 110 percent, welfare begins to fall because the increase in actuarial rate is not enough to compensate for the decrease in the fraction of the population covered. Thus, once we include a choice of plan quality, we find that social welfare is maximized when there is a significant amount of market power, just as in our calibration with advantageous selection.

IV. IMPLICATIONS FOR COMPETITION POLICY

Of course both of these are particular calibrations, using particular models, studying particular data sets; for any given policy application they are unrepresentative. However, they do suggest that, for plausible magnitudes, selection may be a first-order consideration in competition policy.

In the case of adverse selection, blanket limits on competition or forbearance towards mergers and collusion would be, at best, an imperfect policy instrument. Competition has significant benefits in reducing premiums and thus expanding coverage rates.[18] A more effective approach would limit the ability of firms to compete on dimensions that can easily be used for

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[16] Veiga & Weyl, *supra* note 5.

[17] Handel, et al., *supra* note 13.

[18] Leemore Dafny, Mark Duggan, & Subramaniam Ramanarayanan, *Paying a Premium on Your Premium? Consolidation in the US Health Insurance Industry*, 102(2) AMER. ECON. REV., 1161-1185 (2012).

cream-skimming. The ACA incorporates such limits in its regulations. However, the more competitive markets are, the more crucial it will be to ensure such regulations are in place. Furthermore, when such regulations are absent or failing, market power may be more desirable than allowing the market to collapse from cream-skimming.

In the case of advantageous selection, the argument against excessive competition is stronger. Indeed, advantageous selection may explain, or even justify, the extensive exemptions of financial firms from DOJ and FTC oversight under antitrust laws. Other policies, such as raising capital adequacy standards or taxing excessive bank leverage, could be means of limiting excess credit without transferring large profits to banks. However, absent such policies, uncritical support for pro-competitive measures, even and especially if they achieve their intended goals, seems unjustified. At the very least an analysis of the impacts of selection deserve attention similar to that devoted to more traditional antitrust analysis in the financial sector.

While our main goal here is to provoke thought and greater reflection in antitrust analysis on selection, we want to end by highlighting four more concrete implications of our analysis for perhaps the most canonical problem in competition policy: the analysis of mergers. The 2010 United States Merger Guidelines have been widely imitated around the world and embody the rough conventional wisdom on baseline principles for the analysis of horizontal mergers. Criticizing broad principles like these is something of a straw man, given that the Guidelines are careful to highlight their own limitations and space constraints.

However, we do not believe that the concerns selection raises for competition policy are widely understood. To help put this in sharp contrast, we now highlight four intuitions from the guidelines that are no longer appropriate in the context of selection markets, at least on a social surplus standard:

1. *Price-raising incentives are harmful:* Upward Pricing Pressure ("UPP"),[19] the merger-driven incentive of firms to raise prices, has now nearly surpassed concentration measures as the most canonical diagnostic for harms from mergers. However, in selection markets, UPP has a second source beyond the traditional motive (diversion ratio multiplied by mark-up): firms internalize their cream (or dregs) skimming from each other. This suppresses UPP under adverse selection and exaggerates it under advantageous selection; that is, UPP is large precisely when the merger may be beneficial and small when it is most harmful, along this second dimension. Thus UPP is no longer a monotone indicator of how harmful a merger is.
2. *Competition-reduction is a harm diagnostic:* An important motivation behind UPP is that the diversion ratio (the number of sales lost when a firm raises its price that are recaptured by its merger rival), is a useful indicator of the intensity of competition between two rivals that will be removed by the merger. Because competition-reduction is harmful under the usual logic, the greater the diversion ratio the more threatening the merger. However in the presence of advantageous selection it is precisely intense competition that leads to over-supply. Only when competition is very intense, and thus

[19] Joseph Farrell & Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition*, 10(1) BERKLEY ELECTRONIC J. THEORETICAL ECON., (2010).

the good is severely over-supplied, can reducing competition through a merger be beneficial. Thus, under advantageous selection, it may be that the *more* a merger eliminates competition (the higher the diversion ratio between the merging firms) the more likely it is to be beneficial.

3. *Mark-ups over marginal cost are predictive of price-raising incentives:* Other than the diversion ratio, the other term in UPP is the firm's mark-up over its *marginal* cost. This represents the opportunity cost of the sales diverted from the rival when price is lowered, because it is the marginal unit that goes unsold. However, in a selection market it is not just the number of units that are sold, but who they are sold to, that determines cost; in fact, in most realistic cases it is only *who* and not *how many* that determines average cost. This means that marginal cost is only the appropriate measure if the average marginal purchaser from one firm is identical to the average purchaser a firm attracts from its merger partner; that is, if the diversion ratio is 1! Otherwise average cost will often be a better proxy than marginal cost, as average consumers are likely more representative of those attracted from other firms than are marginal consumers attracted from the ranks of the uninsured or unbanked.
4. *Demand data is typically more useful than firm administrative data:* Because internal firm data usually records average costs much more reliably than marginal cost, it has become common to use firm first-order conditions to recover marginal costs using demand data[20] for the purposes of calculating mark-up. A prejudice has thus developed that demand data is typically more important and useful than is administrative data within firms. However, if average cost is a better proxy than marginal cost in the calculation of the relevant mark-up, then administrative data will often be a better guide to costs than demand data, particularly when the latter cannot be linked to the eventual (administratively recorded) costs of the client. At the very least, administrative data is crucial to complement demand data in selection markets, as has been recognized in the growing literature on selection markets.[21]

V. CONCLUSION

We hope to have persuaded the reader that selection, a prevalent phenomenon in many important markets, poses fundamental challenges to competition policy, potentially overturning many established intuitions. Our research has only begun to explore these challenges and offers more questions than it provides answers. We hope that future research will help to establish a more coherent framework for competition policy in these settings and clarify the breadth of cases in which selection is a first-order concern in competition policy.

[20] James N. Rosse, *Estimating Cost Function Parameters Without Using Cost Data: Illustrated Methodology,* 38(2) ECONOMETRICA, 256-275. (1970).

[21] Liran Einav, Amy Finkelstein, & Jonathan Levin, *Beyond Testing: Empirical Models of Insurance Markets*, 2(1) ANNUAL REV. ECON., 311-336. (2010).