RESPONSE OF CLIFFORD CHANCE LLP TO THE CMA'S CALL FOR INFORMATION ON DIGITAL MERGERS

Clifford Chance LLP welcomes the opportunity to respond to the CMA's call for information on digital mergers. Our comments below are based on the substantial experience of lawyers in our Antitrust Practice of advising on merger control procedures for clients active in digital markets, and across a large number of jurisdictions. However, the comments below do not necessarily represent the views of every Clifford Chance lawyer, nor do they purport to represent the views of our clients.

(a) What market features are likely to be relevant to the assessment of mergers in digital markets?

1. We agree that the various factors listed in the call for evidence are relevant to the assessment of mergers in digital markets, i.e. the multi-sided nature of many digital markets, the way in which digital products or services are monetised, payment by non-monetary means, data assets and network effects

2. When covering these features in any updated version of the Merger Assessment Guidelines (**MAGs**), the CMA should elaborate on the factors that indicate whether or not they are relevant. For instance, the prevalence or possibility of multi-homing, the use (mandated or otherwise) of compatibility and interoperability standards and data-portability are all factors that may suggest that network effects for a given digital product or service are not significant.

3. To that list we would also add the following potentially-relevant features:

   (a) The ability of digital operators to price discriminate and the evidence that such ability is used in practice. Many digital products and services allow the gathering of significant amounts of personal user data that can be used to tailor pricing to users' willingness and ability to pay. This can have implications for market definition, e.g. whether markets should be defined according to a distinct category of users or customers. However, consumers tend to react negatively to such price discrimination, which has limited the degree to which it is implemented in practice.

   (b) The availability and substitutability of non-digital, offline or physical products and services. For instance, taxi services that are booked through an app remain in direct competition with those that are booked through other means or hailed on the street.

(b) How might these market features impact the possible theories of harm?

4. We agree that the various factors listed in the call for evidence are relevant to the assessment of how market features may impact the possible theories of harm, subject to the following observations.

   <u>Potential competition</u>

5. We do not consider that the MAGs require significant amendment to account for "actual potential" competition issues in digital mergers. Indeed, we consider that the CMA's

approach in applying the MAGs to recent digital mergers is broadly correct, in particular the reliance on probative documentary evidence to determine the future competitive intentions of the parties in the CMA's recent report on the *PayPal/iZettle* merger.

6. We note that the Lear report suggests that potential competition should be assessed over a period of longer than two years (which it regards as the "default for the assessment of some future market developments").[1] We have no objection to that approach in principle, provided there is sufficient evidence available to the CMA to meet its legal duty to determine that there will be a substantial lessening of competition (**SLC**) on the balance of probabilities, and note that in appropriate cases the UK authorities have assessed counterfactual issues over a longer period in the past.[2] However, any systematic change in the period over which counterfactuals are assessed should also apply to the assessment of the likelihood of future market entry and expansion by third parties, and reflected in paragraph 5.8.11 the MAG.

7. We have not commented here on the suggestion in the Lear report that authorities may need to accept more uncertainty in their assessment of the counterfactual (except to note that, if implemented, such a policy would also require the CMA to accept similar levels of uncertainty when assessing the likelihood of future entry and expansion by rivals).[3] As the Lear report notes, accepting uncertainty on the issue of future potential competition in the counterfactual may result in the CMA falling short of the requisite burden of proof. Consequently, such an approach would, in our view, require legislative amendments to the Enterprise Act 2002 and is not relevant to the CMA's impending revision of the MAGs. The same is true for the "balance of harms" test proposed by the Furman report.[4]

8. As regards theories of harm regarding "perceived potential competition", we do not consider this to be of particular relevance for mergers in digital markets. Such theories of harm can only apply if a merging party is able to ascertain that (i) there is a threat that the other party would enter if existing firms in the market raise their prices (or worsen other aspects of their competitive offering); and (ii) there is no such threat if they do not raise prices. In dynamic digital markets, that level of understanding of the likely future conduct of an operator in another market is rarely achievable and foregoing a profit-maximising strategy on the basis of speculation as to such conduct will involve a significant sacrifice of profits. Consequently, the evidentiary standard for such a theory of harm should be high, i.e. only where a party's internal documents (subject to our comments below about the probative value of such documents) clearly and expressly indicate that perceived potential competition by the other merging party has, in fact, constrained its competitive conduct.

Innovation

9. As regards loss of innovation, we have concerns that a combination of populist pressure and unsubstantiated perceptions of past Type 2 errors (i.e. underenforcement) may result in an expansion of ill-defined and poorly evidenced theories of harm relating to innovation

---

[1] Ex-post assessment of merger control in digital markets, May 2019, page iv.

[2] For instance, in the 2011 final report of the Competition Commission in the Zipcar/Streetcar merger inquiry.

[3] Lear Report, page iv.

[4] Unlocking digital competition, Report of the Digital Competition Expert Panel, March 2019

competition, such that legal certainty is undermined and much needed investment in tech start-ups or other smaller entrepreneurs is deterred.

10. We have particular concerns regarding the application of innovation theories of harm to "innovation spaces" and the approach – adopted by the European Commission in its assessment of the Dow/Dupont merger – of applying a unilateral effects analysis to innovation theories of harm. As explained in more detail in a recent article by Clifford Chance lawyers,[5] that approach relies on an assumption that merged entities can internalise any adverse impact of a reduction in innovation and that this impact and resultant reduction is objectively measurable. In its decisions in relation to innovation theories of harm to date, the European Commission has used R&D spend, R&D headcount, patents and evidence from internal documents to measure the likely impact of a transaction on innovation. For the reasons explained below, each of these measures raises a number of problems which must be acknowledged and addressed in any revisions to the MAGs regarding "innovation spaces" theories of harm:

(a) *Different types of innovation cannot be measured in the same way as price.* Irrespective of whether one considers the CMA to be well placed to adjudicate on the merits of different types of innovation, it is undoubtedly the case that there is no "one size fits all" with regard to the concept of "innovation". For example, "breakthrough innovation", such as the manufacture of a new drug or the launch of an entirely new service, is likely to be easier to detect and measure than "incremental innovation", such as streamlining of processes or the addition of a new means for consumers to access an existing service. It is likely that any impact on "breakthrough innovation" would represent a greater harm to consumers than any reduction in incremental changes which may only serve the purpose of increasing the volume of transactions rather than genuinely advancing the interests of consumers.

(b) *R&D spend and headcount do not necessarily accurately measure innovation.* The European Commission and other authorities have used R&D spend and headcount as a proxy for innovation. However, both of these measures should be treated with caution. In the case of R&D spend, a simplistic assessment of whether, absent the merger, the merging firms would have combined R&D expenditure (or R&D intensity, i.e. the ratio of expenditure to revenue) of the same magnitude as that of the merged entity fails to account for the removal of any genuine duplication of R&D efforts which may result from the proposed transaction. The use of R&D expenditure as a proxy for price rises in a standard unilateral effects analysis also raises a number of material concerns. For example, it is difficult to determine what constitutes a small but significant non-transitory increase in R&D spend because (i) there are significant sunk and fixed costs associated with R&D, which cannot be easily scaled up or down in the way that prices can, and (ii) where companies are operating globally, and across multiple product areas, R&D spending is unlikely to be clearly allocated to defined product or geographic markets.

[5] Innovation theories of harm in merger control: plugging a perceived enforcement gap in anticipation of more far-reaching reforms? Nelson Jung and Elizabeth Sinclair, (2019) 40 E.C.L.R., Issue 6.

Moreover, as recognised by the European Commission's feasibility study,[6] not all R&D spend leads to innovation. In particular, it is common in digital markets for there to be numerous start-up products or services in development, of which only a few make it to the stage of a successful launch. Simply increasing spend at the development stage of the process will not necessarily result in consumer benefits and the same holds true for the opposite case: a reduction in R&D spend will not necessarily result in consumer harm. Further, while some innovation is achieved through investment in in-house R&D, other innovations are brought about through the purchase of other innovators' work. As such, an assessment of innovation on the basis of spend alone appears too speculative and imprecise to form the basis of a robust theory of harm.

(c) *Counting patents is not necessarily an accurate measure of innovation, nor does consolidation of patents necessarily dampen innovation.* Despite their importance for the protection of specific innovations, patents do not necessarily represent an accurate measure of the extent to which firms are competing in relation to innovation in a merger control context. Not all innovations are patented and, conversely, some innovations, particularly in hi-tech industries, give rise to an extremely large number of patents, which can make it difficult to determine the innovative value of each single patent. Patents may also limit innovation by preventing competitors from launching similar products and therefore reducing incentives to conduct R&D activities in the same product area. Moreover, consolidation of ownership in relevant patents can provide important synergies for future innovation. Consequently, using patent numbers as a proxy for a potential loss of innovation competition is fraught with problems and unlikely to provide the foundation for a robust analysis that meets the evidentiary threshold to substantiate concerns.

(d) *Internal documents are not necessarily an accurate indicator of future innovation.* The CMA is increasingly reliant on internal documents to reveal the merging parties' "true" thoughts and intentions. Indeed, evidence from such documents is often used to support theories of harm where economic or empirical evidence is limited or unavailable. While such documents can of course provide useful background, a lack of probative economic evidence supporting an innovation theory of harm should not result in "cherry-picking" documents which, if taken out of context, may look harmful at first sight. All evidence, including internal documents, should be considered in its appropriate context rather than given undue weight in order to plug an "economic evidence gap". Limitations to the probative value of such documents may derive from the fact that they are often created by people without the necessary knowledge or authority to implement the ideas contained therein, may represent early thinking which was quickly rejected or may have been created in order to "sell" a certain view of the world to a specific audience (for example, to potential investors) rather than genuinely reflecting senior management thinking. This is even more so the case if internal documents are being used to support relatively speculative theories of harm in relation to which there is little or conflicting evidence. For example, in Dow/DuPont, the Commission noted that innovation concerns supported by statements from internal documents (which are redacted from the decision) were

[6] Peter Ormosi et al, European Commission, "Feasibility study on the microeconomic impact of enforcement of competition policies on innovation", Final Report (Directorate-General for Competition (European Commission, 2017) para 29.

only supported by approximately 25 per cent of respondents to the market investigation, with the majority of such support coming from the parties' competitors (who likely had a vested interest in opposing the transaction).

11. Even setting aside the arguably insurmountable difficulties of accurately measuring any potential reduction in innovation, an approach focused solely on identifying harm to innovation competition lacks balance unless it takes into account pro-competitive innovation effects arising from a merger, and this should be reflected in any revisions to the MAGs in this respect. Unlike in relation to price, where potential efficiencies are generally limited to cost synergies, a merger may give rise to significant innovation benefits which are much more likely to provide tangible consumer benefits, such as the introduction of new products on an accelerated timescale. In particular, a merger can bring together operators with complementary skillsets whose ability to work together enables them to build on their combined experience to accelerate the development and roll-out of products and services at a faster rate, or into different areas, than they would be able to individually. For example, one party may have access to specific data sets or patents which could potentially be used to develop new products, but may lack the expertise or resources of the other party which would enable this innovation. As such, a merger could unlock pro-competitive benefits for consumers. As noted in the Lear report, "the decisions taken in *Facebook/Instagram* and *Google/Waze* may have represented missed opportunities for the emergence of challengers to the market incumbents, but have also likely resulted in efficiencies".

12. Numerous studies support this view, which is consistent with Joseph Schumpeter's observation that large companies are often well placed and incentivised to innovate.[7] For example, a recent study by the Centre for Competition Policy and the University of East Anglia found that there is no evidence that the consolidation of the HDD market in 2012, as a result of the Seagate/Samsung and Western Digital/Hitachi mergers, reduced the level of innovation.[8]

13. Unlike the European Commission's Horizontal Merger Guidelines, the MAGs make no reference to the fact that a merger can actually increase the merged entity's ability and incentives to innovate, thereby also increasing the competitive pressure on rivals to create new goods and services, and section 5.7 of the MAGs does not include improved innovation as one of the types of efficiencies that it discusses. Moreover, we do not consider that the framework for relevant customer benefits – and the almost unachievable burden of proof on the parties to prove such benefits – is appropriate for the assessment of countervailing innovation effects. Such an approach may be sensible where concerns focus on price as the main parameter of competition, as in those circumstances there is an underlying assumption that if the merged entity will have market power, its incentives to reduce prices for the benefit of consumers are limited. However, as explained above, this assumption is not straightforwardly applicable to innovation, wherein a merged entity active in a fast-moving market has a strong incentive not only to improve existing products, but also to enter entirely new markets and create new demand. As a result, the current framework for analysing merger-specific innovation efficiencies suffers from material flaws and appears, in practice, incapable of accurately reflecting the commercial

---

7 Joseph Schumpter, The Theory of Economic Development (1934); Capital Socialism and Democracy (1942).

8 Anna Rita Bennato et al, "The Effect of Market Consolidation on Innovation in the HDD Industry" (University of East Anglia and Centre for Competition Policy, 2018).

reality of transactions in dynamic markets where innovation is a key competitive parameter.

Non-monetary payment for digital services

14. We have three observations regarding theories of harm regarding the impact on non-monetary "payment" for digital services (e.g. in the form of personal data).

15. First, our view is that such theories of harm are not relevant for those mergers in which there is some monetary payment by users, even if personal data might be considered to be an additional element of the merging parties' pricing. In those cases, there is already a metric against which the competitive effects of the merger can be measured, and any significant reduction in pricing pressure as a result of the merger can be taken as equivalent evidence of a reduction in pressure to improve the quality of their offering in terms of personal data privacy. For example, in a merger between confectionary manufacturers, a finding that the merger would create an incentive to increase prices is an effective proxy for their incentives to reduce pack-sizes or worsen product quality. Digital mergers are no different. Just as the impact on range, quality and service provision is not assessed separately from the impact on pricing in non-digital mergers (except in certain cases of local competition), so the impact on the gathering of personal data does not need separate examination in digital mergers for which monetary pricing can be assessed.

16. Second, in mergers in which there is no monetary price, it is important to focus on those aspects of the impact on personal data gathering that are attributable to a lessening of competition between the merging parties. In many cases, there will be no such connection. A merger between two parties with no competitively-related activities might nonetheless give rise to incentives to gather or combine user's personal data more extensively than in the pre-merger situation. For instance, if a groceries retailer were to acquire a financial services provider, there may be considerable value to be obtained by combining data from grocery shoppers' loyalty cards with data from their financial histories. Irrespective of whether that may be considered to be a reduction in customers' personal privacy, such a combination would have nothing to do with the impact of the transaction on competition between the merging parties.

17. Third, it is not clear to us that the methodological and analytical tools for the assessment of the impact of a merger on the gathering of personal data are sufficiently developed or workable. In particular, while there are some analytical tools that seem to us to focus on the correct issues – such as willingness-to-pay studies in the form of conjoint analysis[9] - they rely on the gathering of very substantial amounts of complex survey data that will usually be unfeasible in the context of a merger review timetable. Moreover, it remains unclear what would amount to a "small but significant non-transitory decrease in privacy" in a digital market, given that in many such markets users display a high degree of tolerance to providing relatively large amounts of personal data.

[9] See "How to measure privacy-related consumer harm in merger analysis? A critical reassessment of the EU Commission's merger control in data-driven markets", Deutscher, Elias (2018), Competition Law for the Digital Economy. ASCOLA Competition Law Series . Edward Elgar. (In Press)

(c) What other theories of harm might arise where the target is active in a complementary market? For example:

(i) Are there circumstances in which efficiency benefits arising from a merger could be considered to give rise to competition concerns?

(ii) To what extent is it important to consider the possibility that a merger could prevent another firm from buying complementary assets and, as a result, be better able to compete?

18. We do not favour the reintroduction of "efficiency offence" theories of harm in merger control. If a merged entity would benefit from efficiencies that improve its competitive offering in ways that existing rivals cannot match, that is the essence of competition. Prohibiting such mergers would not only deprive consumers of superior products and services, it would also dampen rivals' incentives to compete and innovate.

19. However, we recognise that there may be (rare) scenarios in which the properly-evidenced merger counterfactual is one in which a rival would have acquired the target and, as a result, would have been able to improve materially its products or services and so increase competition with a dominant digital operator. Leaving aside the evidentiary hurdles in determining such a counterfactual (which are discussed in paragraph 23 below), the difficulty here is that a policy of prohibiting such mergers would create distorted incentives for investors and rivals. Digital operators may come to understand that they can thwart a larger rivals' acquisitions simply by offering a lower price for the target and irrespective of their intentions to actually proceed with such an acquisition. In addition, investors in start-ups would be deprived of the higher price on offer by larger digital operators, so impacting their exit strategies and their appetite to invest in the first place. For these reasons, we consider that the use of such theories of harm should be exceptional and require particularly compelling evidence of the relevant counterfactual.

(d) How should we approach the assessment of non-price parameters of competition in digital markets?

20. Our comments in paragraphs 15-17 in relation to the collection of personal data above apply equally to other forms of non-price parameters of competition.

(e) When determining the counterfactual:

(i) Which types of evidence should we take into account and how should these be weighted?

(ii) How should we assess: (a) The growth prospects of the target? (b) The availability of other routes for the target to grow (eg by attracting external financing)? (c) The possibility of the target being acquired by an alternative party?

21. We broadly agree with the approach adopted by the CMA in its assessment of the *PayPal/iZettle* merger. In particular, we consider that the best evidence for determining the appropriate counterfactual is submissions of the merging parties and of third parties, combined with verification of those submissions by reference to internal documents (subject to our comments above about the need to take into account the probative value

of certain internal documents). For the assessment of entry and expansion in the counterfactual there is minimal risk that such documents could be prepared for the purpose of "gaming" the merger control system: it would be impossible to develop plans for entry into a new market or expansion in an existing market without generating internal documents and there would be nothing to gain (for the merging parties or for third parties) from generating internal documents that give a false impression of entry or expansion intentions. Such documents may be particularly useful in assessing the availability of alternative financing - as was the case in the *PayPal/iZettle* merger – since it is a commercial imperative for businesses to develop an accurate understanding of the sources of finance available to them.

22. As regards assessing the possibilities of alternative acquisitions in a counterfactual, this is an area in which the CMA should be particularly cautious, for the reasons outlined in paragraph 19 above. The evidentiary difficulties here are that the CMA would have to be able to determine:

    (a) whether the alternative offers were credible (taking into account the possibility that offers may have been motivated by a desire to thwart the merger in question). Clearly, transactions that were at a reasonably advanced stage <u>before</u> the merger under consideration came about and were therefore thwarted by it) will be much more compelling as a counterfactual;[10] and

    (b) whether the seller would have accepted those offers, i.e. what would have been the lowest price and/or highest transaction risk that the target's seller would have accepted in the absence of the merger under consideration. In our view, this is not a factor that is amenable to "second guessing" by the CMA.

(f) What evidential weight should be attached to:

(i) Internal documents indicating that the purpose of the transaction is to eliminate a competitive threat?

(ii) A high transaction value relative to the market value or turnover of the target?

23. See our comments in paragraph 10(d) regarding the probative value of internal documents. For internal documents indicating that the purpose of the transaction is to eliminate a competitive threat, it is particularly important to treat these as purely contextual evidence that may support, but should not replace, robust economic evidence of the competitive effects of a merger. It is also important to consider whether the relevant documents have been created by people without the necessary knowledge or authority to assess the competitive effects of a merger. Even if an employee genuinely believes that a merger will eliminate a competitive threat, that does not mean that it will actually do so.

24. We also consider that high transaction values are, at best, relatively weak and circumstantial evidence of an anticompetitive transaction rationale and should therefore be used only in the context of supporting other, more probative evidence, if at all. Where

[10] For example, in the BskyB/ITV merger, the Competition Commission considered whether the counterfactual should have been ITV's acquisition by Virgin, pursuant to an acquisition by way of a scheme of arrangement that had already been launched, but concluded from ITV's contemporaneous board minutes that such a merger was unlikely to have been implemented.

such evidence is used, the CMA should not engage in second guessing the parties' internal valuations on matters such as the expected efficiencies or synergies arising from the transaction. In particular, when assessing transaction synergies, businesses and investors do not insist on the unreasonably high standards of proof that the CMA and other authorities do when deciding whether to take into account countervailing efficiencies in the merger assessment. Equally, however, where valuations appear to assume future price increases or a reduction in revenue growth the CMA should examine carefully whether these really are probative evidence that the merger will have anticompetitive effects. As is the case for other types of internal document, an employee's belief may be contradicted by stronger and more probative evidence showing that the merged entity would have no ability to increase prices, such as surveys and economic merger simulations. Similarly, a projected reduction in revenue growth may indicate that a buyer has a less optimistic (and more realistic) view of the target's growth prospects that the seller, rather than being evidence of a plan to reduce output.

(g) Are there particular features of digital mergers that would be relevant to our assessment of efficiencies and relevant customer benefits?

25. As a broad generalisation, digital markets have a greater tendency than non-digital markets to be dynamic and fast-moving, with innovation as an important component of competition. As noted in paragraph 13 above, businesses active in such markets have strong incentives not only to improve existing products, but also to enter entirely new markets and create new demand. As a result, innovation efficiencies are much more likely to arise in respect of digital mergers. In our view, the current framework for analysing merger-specific innovation efficiencies suffers from material flaws and appears, in practice, incapable of accurately reflecting the commercial reality of transactions in dynamic markets where innovation is a key competitive parameter.

(h) Are there any other aspects of the MAGs that should be supplemented or revised in relation to mergers in digital markets?

26. See our responses to the questions above.

Clifford Chance LLP
July 2019