

**RECENT DEVELOPMENTS IN EC MERGER CONTROL REFORM: (1)
PROPOSED AMENDMENTS TO THE MERGER CONTROL REGULATION, AND
(2) PROPOSED GUIDELINES FOR THE ANALYSIS OF HORIZONTAL MERGERS**

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**OVERVIEW OF EC MERGER
CONTROL REFORM**

In December 2001, the European Commission issued a Green Paper proposing significant and widespread reforms to European merger control. The ensuing year-long review of these proposals culminated last week with the issuance of a draft of the proposed amendments to the existing EC Merger Regulation (the "ECMR") and a draft Commission notice on the guidelines for the evaluation of horizontal mergers (the "proposed Horizontal Merger Guidelines").

While the process of reforming European merger control practice began over a year ago, developments over the past year have heightened the significance of the proposed reforms. Most notably, the evolution of judicial review of Commission decisions in the European courts has brought a new critical voice to the need to reform existing Commission practice, the European Court of First Instance (the "CFI"). In the past year, under a new "fast track" procedure, the CFI has, for the first time, reversed Commission merger control decisions. Indeed, the CFI decisions in *Airtours*, *Schneider*, and *Tetra Laval* not only represented a significant setback for Commission regulators, and have heightened the scrutiny of existing procedures and practices.

The following memorandum provides an overview of the significant reforms proposed by the Commission.

**THE PROPOSED AMENDMENTS
TO THE EC MERGER REGULATION**

The ECMR is the regulation that sets forth both the procedures and standards by which the Commission evaluates proposed concentrations.¹ The proposed reforms to the ECMR can be roughly categorized as reform to (1) the allocation of jurisdictional authority between the Commission and the Member States, (2) the substantive standards that govern such review by the Commission, and (3) the procedures by which the Commission reviews concentrations.²

**PROPOSED REFORMS TO THE
ALLOCATION OF JURISDICTIONAL AUTHORITY**

The existing ECMR provides for two thresholds by which the Commission is allocated exclusive jurisdiction over transactions.³ While these jurisdictional thresholds are designed to allocate all concentrations which present a Community dimension to the exclusive jurisdiction of the Commission, practice has demonstrated that the thresholds fail to capture all such concentrations. The result of this under inclusion has been to subject many transactions to multiple merger control filings in Europe, the very thing that the ECMR was designed to prevent.

In its Green Paper, the Commission proposed a so-called “3+ system” which would allocate exclusive jurisdiction to the Commission in all concentrations where merger control filings were required in three or more Member States. The current proposals, however, reject the 3+ system for several reasons. First, the Commission determined that not all concentrations that required filings in three or more Member States pose a Community dimension. Second, due to significant variances in Member State jurisdictional thresholds, the Commission determined that the 3+ system would fail to include some concentrations currently captured under the ECMR’s existing thresholds, thereby depriving the

¹ The term “concentration” is used by the Commission, and in this memorandum, to describe, among other things, transactions ranging from mergers to acquisitions of controlling interests in existing businesses and the formation of joint ventures. For further guidance on the range of transactions governed by the ECMR, please refer to the Commission’s Notice on the Concept of Concentration under the ECMR, OJ C 66, 2.3.1998.

² It should be noted that the standards and procedures set forth in the ECMR are binding only on the Commission. Merger control authorities in the Member States are not bound by the standards and procedures set forth in the ECMR, save to the extent that the ECMR provides for preemption of Member State jurisdiction. Indeed, both procedures and the substantive standards governing the review of concentrations in the various Member States can, and frequently do, differ significantly and materially from those set forth in the ECMR.

³ See ECMR at Article 1(2) and Article 1(3).

Commission of the opportunity to review some concentrations which pose a Community dimension. Finally, the Commission determined that these various differing Member State thresholds would introduce unacceptable legal certainty into the merger control process, as the Commission and the Member States could potentially disagree as to whether a concentration was notifiable under a Member State's regulation.

Thus, the Commission has designed a flexible system of cross-referrals to compensate for existing flaws of the ECMR. The main elements of the proposed system are the following enhancements to the current referral mechanism provide for in Articles 9 and 22 of the ECMR:

- providing for referrals both by Member States to the Commission and by the Commission to the Member States;
- extending the application of Articles 9 and 22 to the pre-notification stage, by which the notifying parties will have the exclusive right to request referral of the case either to the Commission or to the Member States;
- conferring exclusive jurisdiction on the Commission if at least three Member States with jurisdiction to review a concentration agree to refer a case to the Commission that currently falls under the ECMR thresholds; and
- providing the opportunity for the Commission to invite Member States either to make voluntary referrals to the Commission or to accept the voluntary referral of a case by the Commission.

Collectively, these reforms are designed to allow for the efficient referral of concentrations within the Community to the regulatory authority that is in the best position to evaluate the competitive concerns presented. Notably, these reforms permit the parties to initiate inter-Community referrals in the pre-notification stage and, further, give the Commission the authority to initiate such referrals *sua sponte*. The Commission believes that unlike the relatively crude 3+ system, this flexible system of referrals benefits from precisely targeting those concentrations presenting a Community dimension for review by the Commission, while allocating the balance to the Member States.

PROPOSED REFORMS TO SUBSTANTIVE STANDARDS GOVERNING EC REVIEW

The proposed amendments to the ECMR do not incorporate many of the substantive reforms initially proposed by the Green Paper. Most notably, the Commission has decided not to replace the governing standard for anticompetitive harm from the current "creation or strengthening of a dominant position" (the "dominance" standard) to the "substantial lessening of competition" (the "SLC" standard) pioneered by the United States and recently adopted by, among others, the United Kingdom and Ireland. In short, the Commission determined that more subtle reforms would close whatever gaps in enforcement existed

between current EC practice and jurisdictions applying the SLC standard without sacrificing the precedent developed over the last decade by the Commission and the European Courts under the dominance standard.

The proposed amendments, therefore, clarify, rather than replace, the existing dominance standard provided in Article 2 of the ECMR. These clarifications make clear that the concept of “dominance” encompasses situations where a concentration in an oligopolistic market results in the ability of one or more members of the oligopoly to influence the parameters of competition, even without coordination between the members of the oligopoly. Moreover, the proposed amendments provide that such concentrations violate the dominance standard even if the creation of market power does not lie in the merged entity, but rather in a third party competitor in the market.

The other significant substantive change to the ECMR resolves the so-called “multiple transaction.” Under the current ECMR, a transaction that occurred in several stages could, depending upon the structure, be considered several concentrations for EC merger control purposes. The “multiple transaction” problem has resulted, in practice, in multiple filings, both to the Commission and to the Member States in cases where the small transactions comprising the full transaction do not satisfy the ECMR jurisdictional thresholds. The proposed amendments to Article 3(4) of the ECMR would eliminate the “multiple transaction” problem by providing that transactions which are conditional on one another or transactions that are closely connected in their economic rationale will be treated as a single concentration under the ECMR. This proposal will eliminate both the need for multiple merger control filings at the Commission, and make it easier for transactions to qualify for exclusive Commission jurisdiction.⁴

Finally, as discussed below in the context of the proposed Horizontal Merger Guidelines, the Commission reaffirmed its stance that as Article 2(1)(b) of the existing ECMR already requires the Commission to take into account the efficiencies created by a proposed concentration and so there was no need to further amend the ECMR in this regard.

**PROPOSED
PROCEDURAL REFORMS**

For the vast majority of future transactions, the impact of the proposed amendments to the ECMR will most keenly be felt in the amendments made to the procedural rules governing the practice of EC merger control investigations.⁵ These proposed procedural rules will both provide flexibility in the timing of EC merger control investigations and enhance the EC’s ability to coordinate the timing of many investigations with their

⁴ Notably, this reform brings EC practice more in line with current U.S. merger control practice.

⁵ While the Commission has also stated that it intends to promulgate best practices guidelines for the Merger Task Force, such guidelines have not been made publicly available as of the date of this memorandum.

counterparts in the United States and Canada, but may also significantly lengthen the waiting periods for EC regulatory clearance for many transactions. The most significant procedural reforms proposed by the Commission are as follows:

- allowing transacting parties to notify a transaction upon demonstration to the Commission of a good-faith intention to conclude a binding agreement between the transacting parties; heretofore, transacting parties could only notify a transaction to the Commission after such an agreement had been concluded;
- eliminating the one-week deadline for submitting a notification to the Commission;
- enlarging Phase I of the investigation in general, and by approximately one-week in the event that the parties submit undertakings to the Commission to remedy perceived competitive concerns posed by the concentration;⁶
- enlarging Phase II by 15 working days should the parties submit undertakings before the 55th working day of the merger investigation; and
- providing for the possibility to extend Phase II by up to 20 working days in complex cases upon the unilateral request of the parties, or by the Commission with the consent of the parties.⁷

While these proposals will greatly enhance the flexibility of the parties and the Commission to resolve any perceived competitive threats posed by a transaction, these proposals also threaten to inhibit the parties' ability to achieve a timely resolution of the EC investigation in complex cases.

Moreover, the Commission, in light of the recent reversals of its decisions by the CFI, has also clarified the procedures parties must follow in the event the CFI or the European Court of Justice (the "ECJ") annuls in whole, or in part, future Commission decisions. The proposed amendments to Article 10(5) require parties to submit either a new or supplemental notification to the Commission "without delay" following reversal of a Commission decision in the CFI. Thus, in the event that parties are successful in

⁶ Unlike the current ECMR, the proposed amendments also convert all deadlines to working days. The proposed Phase I deadline in all merger investigations is 25 working days, which approximates the current one-month deadlines. Should the parties offer undertakings to the Commission, the Phase I deadline is extended to 35 days under the proposed amendments, approximately a one-week extension from the prior six week deadline.

⁷ The proposed amendments require the parties to make a request to extend the Phase II deadline no later than 15 working days into the Phase II investigation. The Commission, however, can request that the parties agree to extend Phase II at any time. The amendments further provide that while the parties may require the Commission to extend Phase II only once, the Commission can request multiple extensions of the Phase II deadlines.

overturning, even in part, a Commission decision in the European courts, the parties will face an entirely *de novo* Phase I, and likely also a Phase II, investigation.⁸

Finally, the proposed amendments enhance the Commission's discovery and enforcement powers, as well as the fines that compel compliance with them. First, the proposed amendments confirm the Commission's power to compel interviews of natural persons during merger investigations and, with the interviewee's consent, record such oral submissions for use as evidence in future proceedings. Second, the Commission refused to extend its investigatory powers in merger investigations to include either sector inquiries or home searches. Finally, the Commission clarified its powers to enforce its decisions in cases where mergers have already been implemented. Under Article 8(4) of the proposed amendments to the ECMR, the Commission is expressly given the authority to take whatever actions are necessary in order to restore the competitive *status quo ante* to the market. Thus, the Commission may, under the proposed amendments, order any appropriate interim measures, in addition to a complete rescission of the transaction, to restore the competition that was distorted by virtue of the prohibited concentration. Such remedial measures may include hold separate orders and the cessation of the exercise of joint control, among other remedial interim measures. The proposed amendments to Article 8(5) also grant the Commission widespread power to remedy the competitive harm caused by concentrations implemented in contravention of Article 7 of the ECMR or of an undertaking given by the parties and upon which the Commission's decision clearing the transaction was conditioned.

The Commission greatly increased the potential fines for failure to fully cooperate with the Commission's investigation or comply with its decisions. For example, the proposed amendments increase the fine for providing incorrect, incomplete, or misleading information in a notification or in an oral interview from €50,000 to a maximum of 1% of the turnover of the notifying party. The proposed amendments also enhance the periodic fines designed to compel full and complete disclosures to the Commission to a maximum of a daily fine of 5% of the daily aggregate turnover of the relevant party. Equivalent fines are provided for noncompliance with Commission decisions.

OVERVIEW OF THE PROPOSED HORIZONTAL MERGER GUIDELINES

The proposed Horizontal Merger Guidelines set forth, for the first time, insight into the Commission's decision-making process in analyzing concentrations between parties

⁸ Unlike, for example, the American system, which entrusts final authority over merger control policy to the Courts, the European system gives final authority over merger control policy to the Commission. Thus, while a final adverse ruling in an American court leaves U.S. regulators without recourse to enjoin the consummation of a transaction, the EC may, at its discretion, re-review any transaction in which its decision has been overturned.

which are active, or potentially active, in the same market. Specifically, the proposed Horizontal Merger Guidelines detail the Commission's analysis in the following areas:

- determining the likelihood of anticompetitive effects stemming from the concentration;
- determining whether there is sufficient buyer power to offset any resultant anticompetitive effects;
- determining whether entry will be effective to restore any lost competition resulting from the concentration;
- the identification and quantification of efficiencies; and
- the prerequisites to mounting a so-called "failing firm" defense.

While the Commission declined to take a definitive position on many issues outlined in the proposed Horizontal Merger Guidelines, the document is helpful for parties in assessing the antitrust risk posed by a proposed transaction.

**ANALYSIS OF THE LIKELIHOOD
OF ANTICOMPETITIVE EFFECTS**

The proposed Horizontal Merger Guidelines identify several categories of potential anticompetitive effects that could result from a horizontal concentration. Notably, as in the proposed amendments to the ECMR, the Commission has focused extensively on the analysis of horizontal concentrations in oligopolistic markets.⁹ The proposed Horizontal Merger Guidelines set forth three principle ways in which horizontal concentrations could result in the creation or strengthening of a dominant position:

- By creating or strengthening a "paramount" position. Firms with a paramount market share can increase prices, reduce output, reduce consumer choice, reduce the quality of goods or services, diminish technological innovation, among other things (collectively, "anticompetitive effects" or "anticompetitive behavior"), without being constrained by countervailing actions by their customers, suppliers, or actual or potential competitors. This

⁹ The Commission's attention to transactions in oligopolistic markets is due to the perceived weakness of the "dominance" standard by which violations of EC law are judged. While a concentration between two smaller players in an oligopoly clearly can result in a "substantial lessening of competition," particularly if the acquired party has demonstrated a tendency to charge lower prices or increase output above the market average (a "radical competitor"), there has been some disagreement over whether such a concentration can also lead to an "creation or strengthening of a dominant position." The proposed amendments to the ECMR and the proposed Horizontal Merger Guidelines emphatically resolve that debate in the affirmative.

analysis is similar to the unilateral effects analysis in the U.S. Horizontal Merger Guidelines.

- By diminishing competition in an oligopolistic market. Such concentrations can eliminate important competitive restraints on one or more sellers, which would consequently result in anticompetitive effects in the market.
- By altering the nature of competition in an oligopolistic market. Such concentrations facilitate coordination among competitors on anticompetitive behavior.

Determining Market Characteristics

The proposed Horizontal Merger Guidelines, much like their U.S. counterparts, rely heavily on market shares and the Herfindahl-Hirschman Index (“HHI”) to initially identify transactions which may prompt investigations by regulators.¹⁰ Although the Commission declined to provide for a “safe harbor” for any transaction based solely on the HHI calculation, the proposed Horizontal Merger Guidelines provide that the Commission is unlikely to investigate cases where the post-concentration HHI is less than 1,000.

Significantly, however, the Commission stops just short of creating a bright-line test for the absolute prohibition of concentrations. The Commission does, however, quantify the concept of a “dominant position” as, in most cases, a market share greater than 50%.¹¹ Moreover, where the combined market share post-concentration is less than 50%, the Commission will look, *inter alia*, to the market positions of competing firms to determine whether the new entity will wield a dominant share post-closing.

In refining its analysis of market power, the Commission will also examine the following factors:

- whether economies of scale and scope give the new entity a strategic advantage over smaller competitors;
- whether the new entity has privileged access to supply, resulting from vertical integration or the establishment of sufficient control over the supply of upstream products;

¹⁰ HHI is calculated by summing the squares of the individual market shares of all the firms in the market. The change in HHI pre and post concentration is a proxy for the competitive effect of a proposed transaction. As such, the HHI analysis gives a disproportionate effect to the market shares of larger firms.

¹¹ The proposed Horizontal Merger Guidelines state that “very large market shares – in excess of 50% -- may be in themselves, save in exceptional circumstances, evidence of a dominant market position, in particular where the other competitors on the market hold much smaller shares.” *See* Proposed Horizontal Merger Guidelines at ¶ 20.

- whether the new entity has a highly developed distribution or sales network that competitors would find difficult to replicate;
- whether the new entity has access to essential facilities or leading technologies that result in a competitive advantage over competitors; and
- whether the new entity has privileged access to specific inputs, including financial capital.¹²

While the proposed Horizontal Merger Guidelines expressly admit that many of these factors may result in a benefit to consumers, the guidelines also affirm the long-standing position of EC regulators that such competitive advantages “make it difficult for competitors, either individually or in the aggregate, to effectively constrain the paramount firm to a sufficient degree,” and will therefore result in long-term anticompetitive effects. Moreover, the Commission makes clear that it will not limit its inquiry to the above factors. Where relevant, the Commission will also consider the elimination of other competitive restraints, such as the elimination of inter-brand rivalry or the elimination of a radical competitor.

Finally, the proposed Merger Guidelines provide that in assessing the likelihood of anticompetitive effects, the Commission will consider the likelihood that some combination of sufficient entry, buyer power or efficiencies will offset the anticipated anticompetitive effects of a concentration.

Analyzing Concentrations in Oligopolies

The proposed Horizontal Merger Guidelines admit that competition can be and often is robust in oligopolistic markets. Thus, the analysis of anticompetitive effects requires greater scrutiny here, than in markets characterized by a participant with a dominant market share. In short, the proposed Horizontal Merger Guidelines treat oligopolies differently based on the types of products offered. In markets where products are relatively homogeneous, a concentration leading to a HHI of 2000 or greater, with an increase in HHI of 150 or more, will raise serious competition concerns. In markets where products are differentiated to a significant degree, the Commission will engage in a fact-finding exercise to determine the degree of substitutability between the various products offered. For example, the Commission may look to data generated by consumer preference surveys, historical analyses of purchasing patterns, and the estimation of cross-price elasticity of demand between the various products. Finally, the proposed Horizontal Merger Guidelines provide that in markets where the combined market share of the new entity does not exceed 25%, the Commission is unlikely to investigate the merger provided that the products of the remaining competitors in the market are sufficiently close substitutes.

¹² Privileged access to financial capital will be considered only where finance is relevant to the competitive process in the industry, there are significant asymmetries between competitors in terms of internal financing capabilities, and where particular features of the relevant industry make it difficult to attract external financing.

In addition to the traditional anticompetitive effects of horizontal concentrations, the proposed Horizontal Merger Guidelines set forth the Commission's analysis of whether a concentration may facilitate coordination among participants in an oligopoly. For a market to be susceptible to coordination among competitors, participating firms must be able to establish the terms of coordination, monitor compliance with such terms, and punish deviating firms by establishing sufficient mechanisms to deter cheating. As the proposed Horizontal Merger Guidelines note, competitors may coordinate on a variety of competitive behavior, including pricing, output, and division of the marketplace.

Horizontal concentrations that result in cross-shareholdings or participation in joint ventures between competitors in a market can therefore facilitate coordination by providing a strong deterrent to cheating, either in the form of cancellation of the joint venture or sale of the shares held by the deviating firm's competitors. Moreover, as coordination is easier in markets where competitors have similar cost structures and market shares, concentrations promoting such symmetry among competitors in a market can raise coordination concerns. Finally, concentrations resulting in the increased ability of firms to monitor each others' strategic behavior will draw significant attention from the Commission, as such concentrations greatly enhance firms' ability to monitor compliance with the terms of coordinated behavior.

ANALYSIS OF COUNTERVAILING FORCES TO ANTICOMPETITIVE EFFECTS

The proposed Horizontal Merger Guidelines identify three primary sources of countervailing forces that could offset the Commission's preliminary finding of anticompetitive effects resulting from a concentration: (1) buyer power; (2) entry; and (3) efficiencies.

In some cases, sufficient market power in the hands of the transacting parties' buyers can be sufficient to offset any potential anticompetitive threats posed by the concentration. The proposed Horizontal Merger Guidelines define buyer power in this context, therefore, as the ability of large customers, within a reasonable timeframe, to resort to credible alternatives if a supplier decides to increase prices or otherwise alter the conditions of delivery. Thus, parties can demonstrate the existence of buyer power through the availability of other suppliers, the possibility that buyers may vertically integrate, or the potential for upstream entry sponsored by such buyers.

The proposed Horizontal Merger Guidelines reiterate the well-established rule that entry must be likely, timely, and sufficient to offset the anticipated anticompetitive effects. This rule is based on the logic that where a profit level in an industry is artificially high, due to the absence of competitive pressures on the participants, entrepreneurs will enter the market to obtain a share of those profits, thereby driving prices down to competitive levels. For entry to constitute a successful defense to a finding of anticompetitive effects, the parties must therefore show the absence of barriers obstructing entry into the market. Where entry

barriers are low, competitors in the market are more likely to be restrained by entry. The proposed Horizontal Merger Guidelines identify the following categories of entry barriers:

- legal barriers, including required licenses to compete in the market or otherwise limit the number of competitors;
- technological advantages, including access to essential facilities, natural resources, innovation and R&D, or other intellectual property rights;
- disparity in economies of scale and scope, or the existence of distribution and sales networks; and
- established positions of incumbents based on experience, reputation, brand loyalty, or high costs to customers associated with switching suppliers.

In analyzing entry, the Commission will look to historical evidence of entry in the market and the ability of potential entrants to enter the market in a timely and sufficient way. In an industry where successful entry has already occurred, the Commission is unlikely to find the existence of entry barriers. Conversely, in an industry where previous attempts at entry have failed, the Commission will presume that future entrants will also fail. Finally, the Commission will look at the range of potential entrants to assess whether they have the capabilities, in relevant production, distribution, or other facilities, to make for a successful entrant.

Finally, the proposed Horizontal Merger Guidelines admit to the possibility that efficiencies can offset potential anticompetitive harm posed by a concentration. In short, the parties will need to provide the necessary proof establishing that the efficiencies claimed are merger specific, substantial, timely, and verifiable. The Commission, however, has set a very high standard of proof for such efficiencies. First, the parties must demonstrate that the efficiencies are likely to enhance the incentives of the new entity to act pro-competitively for the benefit of consumers. The proposed Horizontal Merger Guidelines state that the best evidence of such is proof that the efficiencies will reduce variable or marginal costs, rather than fixed costs. Second, the parties must demonstrate that the claimed efficiencies result entirely from the concentration and could not be realized in its absence. Third, the parties must demonstrate that the efficiencies will be realized in the short term following closing, as it is difficult to quantify efficiency gains over time. Finally, the parties must be able to quantify the efficiency gains. The proposed Horizontal Merger Guidelines suggest that an efficiencies defense will moreover only succeed where the claimed efficiencies are substantial and the potential anticompetitive harms are small.

**ANALYSIS OF THE
"FAILING FIRM" DEFENSE**

Where a deterioration of the competitive structure of a market will occur regardless of the proposed concentration, the Commission will consider permitting the concentration

under the failing firm doctrine. In short, the failing firm doctrine permits a firm to acquire another firm on proof that the target would imminently exit that market due to financial constraints. The proposed Horizontal Merger Guidelines set forth the standard of proof needed to maintain a failing firm defense to a concentration posing anticompetitive effects. First, the parties must demonstrate that the target would, in the near future, be forced out of the market because of financial difficulties. Second, the parties must demonstrate the absence of a less anticompetitive alternative solution to the proposed concentration. Finally, the parties must demonstrate that, in addition to the target exiting the market, the assets of the failing firm would inevitably exit the market as well. If all three elements can be met, the Commission will consider allowing the transaction, even if the concentration would result in the creation or strengthening of a dominant market position.

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These proposals are currently in draft form, and expressly provide for public comment on their contents. The deadline for the submission of comments on the proposed amendments to the ECMR and the proposed Horizontal Merger Guidelines is March 31, 2003. If you have any questions or would like further information, please contact Kenneth R. Logan (212-455-2650, klogan@stblaw.com), David E. Vann Jr. (+44 (0)20 7275 6550, dvann@stblaw.com), Ethan E. Litwin (+44 (0)20 7275 6463, elitwin@stblaw.com), or Olivier Antoine (212-455-2991, oantoine@stblaw.com) in the Firm's antitrust group.

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