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COMMENTS OF ITIF

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PROTECTING INNOVATION: WHY THE DRAFT MERGER GUIDELINES FALL SHORT

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INTRODUCTION

On July 19, 2023, the Department of Justice's Antitrust Division (DOJ) and the Federal Trade Commission (FTC) issued for public comment Draft Merger Guidelines that describe the Agencies' analytical framework for reviewing mergers and acquisitions under the antitrust laws.[1] The Schumpeter Project on Competition Policy of the Information Technology and Innovation Foundation (ITIF) appreciates the opportunity to comment on the Draft Merger Guidelines, and specifically to highlight their deficiencies with respect to the role of protecting innovation.

ITIF applauds the DOJ and FTC for working to ensure that their Merger Guidelines are attuned to "the realities of how firms do business in the modern economy,"[2] and in particular, the New Economy markets that have rapidly transformed our way of life and delivered seemingly immeasurable benefits for consumers and our broader society. As courts have recognized, fundamental to this "rapid technological change" is using antitrust law to protect a competitive process in which "firms compete through innovation for temporary market dominance, from which they may be displaced by the next wave of product advancements."[3]

This dynamic competition is crucial to the well-functioning of market democracies. Innovation has not only long been understood as the principal driver of long-run economic growth,[4] which helps provide the

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[1] Press Release, Fed. Trade Comm'n & Dep't of Justice, FTC and DOJ Seek Comment on Draft Merger Guidelines (July 19, 2023).

[2] *Id.*

[3] U.S. v. Microsoft, 253 F. 3d 34, 49 (D.C. Cir. 2001) (citations omitted).

[4] *See* Robert M. Solow, *Technical Change and the Aggregate Production Function*, 39 REV. ECON. & STAT. 312 (1957); *see also* Charles I. Jones, *Sources of U.S. Economic Growth in a World of Ideas*, 92 AM. ECON. REV. 220 (2002).

foundation for a stable democracy, but has also enabled the general purpose technologies[5] that have empowered the many against the few, like the printing press and the Internet.[6] Given that the leaders of both the DOJ and FTC have emphasized that antitrust law should not just be narrowly focused on quantifying static price effects, but as a tool to promote competitive markets and political democracy,[7] innovation should be a core area of focus for the Draft Merger Guidelines.

Unfortunately, while the Draft Merger Guidelines are in almost all other respects extensive in setting forth the Agencies' views, they contain very little focused discussion on innovation, which is almost entirely relegated to two short sections in Appendices 2 and 3.[8] In so doing, the Draft Merger Guidelines neglect crucial aspects of how competition works in the very New Economy markets that they are in large part designed to address. And, as such, with respect to providing guidance as to how the Agencies will approach mergers involving innovation, they reflect no discernable improvement upon the 2010 Horizontal Merger Guidelines.

On the contrary, by invoking new concentration thresholds untethered to the economics surrounding the relationship between market structure and innovation, the Draft Merger Guidelines represent a major setback for protecting innovation. Indeed, by contemplating the use of these thresholds to presume harm to competition from mergers in markets where innovation is a key dimensionality of competition, the Draft Merger Guidelines reflect not only misguided economics, but—in a way analogous to structural presumptions themselves—a snapshot of the relevant Supreme Court case law.

This comment proceeds in five parts. The first provides an overview of how the process of dynamic competition functions in many markets. The second explains how the structural presumption in *United States v. Philadelphia National Bank*[9] must be interpreted with a "Schumpeterian proviso" in light of the Supreme Court's subsequent decision *United States v. General Dynamics*.[10] The third demonstrates how the Draft Merger Guidelines are substantially out of step with sound legal and economic principles for applying antitrust law to protect innovation competition. The fourth provides several recommendations for the Agencies to consider toward promoting this dynamic competition in their merger guidelines. A brief conclusion follows.

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[5] *See* Philippe Aghion, Ufuk Akcigit & Peter Howitt, *What Do We Learn From Schumpeterian Growth Theory*?, NBER Working Paper 18824 at 29 (2013) (noting that "GPTs are Schumpeterian in nature, as they typically lead to older technologies to be abandoned as they diffuse to these sectors").

[6] In the words of then former President Reagan, "[t]echnology will make it increasingly difficult for the state to control the information its people receive …. The Goliath of totalitarianism will be brought down by the David of the Microchip." Ronald Reagan, Speech at London's Guildhall (June 14, 1989).

[7] *See, e.g.*, Jonathan Kanter, Assistant Attorney Gen., U.S. Dep't of Justice, Antitrust Div., Assistant Attorney General Jonathan Kanter Delivers Remarks on Modernizing Merger Guidelines, (Jan. 18, 2022) ("The FTC and DOJ are fighting on the front lines to preserve competitive markets, which are essential to a vibrant and healthy democracy.").

[8] *See* FED. TRADE COMM'N & DEP'T OF JUSTICE, DRAFT MERGER GUIDELINES Appendix 2.E, Appendix 3.B.7 (July 19, 2023) [hereinafter DRAFT MERGER GUIDELINES].

[9] 374 U.S. 321 (1963).

[10] 415 U.S. 486 (1974).

THE ECONOMICS OF SCHUMPETERIAN COMPETITION

Innovation is not a law of nature. Rather, firms face several core problems they must solve if they want to engage in dynamic competition. As distinct from the need to think creatively,[11] or even more critically overcome the challenges associated with cannibalizing existing products,[12] an essential problem involves the sheer lack of certainty firms face when assessing whether the new innovation will be profitable.[13] For myriad reasons, a firm may invest substantial resources in a new technology only to find later that it is unable to appropriate the benefits wrought by its own innovation: only in hindsight do we determine whether an innovation is successful, and for every "Apple" or "Google" there are scores of failures.

Since the groundbreaking work of Joseph Schumpeter in the 1940s, it has long been understood that competition is not merely, as neoclassical economics holds, an equilibrium where price equals marginal cost. Nor is it simply, as Adam Smith imagined, a rivalry between many sellers in a market. Rather, as Schumpeter explained, innovation or dynamic competition occurs through "gales of creative destruction"[14] whereby one firm competes *for* the market by creating a new product, only to be challenged by additional "leapfrog competition"[15] that supplants the formerly dominant firm with a still newer product that not just dazzles consumers but allows for the firm to recoup the costs of its innovation.

Schumpeter's theory of innovation competition, which can either be incremental or drastic in nature, helps elucidate the amazing transformation of economic life in the West from a more atomistic economic system largely constituted by small and regional firms defined by static forms of competition to one driven by large, national, and now international concerns powered by scale economies and R&D-driven innovation. Viewed in this dimension, economic concentration is a feature—not a bug—of not just a competitive process to facilitate innovation and economic growth, but the evolution of capitalist society itself.[16]

Indeed, the success of the information economy in America reflects a concrete example of Schumpeterian competition at work: IBM's leadership in personal computing was displaced by Microsoft's paradigm-shifting operating system, which was in turn leapfrogged by the Internet tidal wave beginning with Google (who surpassed Yahoo!) in general search, who saw its position in advertising challenged by Facebook (overcoming MySpace) in social media. This cycle, which continues today, led to the rise of the American technology titans

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[11] *See* CLAYTON CHRISTENSEN, THE INNOVATOR'S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL (1997).

[12] *See* Kenneth Arrow, *Economic Welfare and the Allocation of Resources to Invention*, *in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY: ECONOMIC AND SOCIAL FACTORS 609 (1962).

[13] *Id.* at 622 (conceding that "monopoly may create superior incentives to invent [because] appropriability may be greater under monopoly than under competition")

[14] JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 81 (1942).

[15] Thomas O. Barnett, *Interoperability Between Antitrust and Intellectual Property*, 14 GEO. MASON L. REV. 859, 860 (2007).

[16] SCHUMPETER, at 106 ("What we have got to accept is that [the large-scale establishment or unit of control] has come to be the most powerful engine of [economic] progress.…In this respect, perfect competition is not only impossible but inferior, and has no title to being set up as a model of ideal efficiency.").

that are the economic envy of the world—each not only driving innovation, but competing with one another as they do it.[17] And that technological leadership led to increased global market share, driving U.S. jobs and competitiveness.

Schumpeter's insights have thus more than withstood the test of time. While the general relationship between market structure and innovation has long been a matter of great debate,[18] numerous studies across many economies around the world continue to confirm that the relationship often takes the form of an inverted-U, where markets characterized by many firms demonstrate less innovation than markets with a few firms, and markets with a few firms exhibit more innovation than those characterized by monopoly.[19] Indeed, in some U.S. studies the relationship is negative,[20] and thus strongly supportive of the Schumpeterian thesis that firms in less concentrated markets lack incentives to engage in the risk-taking and R&D that enables innovation. The implication is profound: consolidation may often enhance dynamic competition.

Mergers and acquisitions can also enhance innovation in other more nuanced ways. As economists have recognized, firms can face knowledge limitations that restrict their capacity to adapt to large scale innovations. Specifically, and building upon the insights of Edith Penrose, it has been recognized that firms which seek to engage in disruptive innovations may lack the necessary expertise in related and existing product markets.[21] On this theory, to support Schumpeterian competition, increased product diversification, such as from conglomerate mergers and acquisitions, can be useful toward facilitating the knowledge growth needed to support the "dynamic capabilities" that enable new product creation and Schumpeterian competition.[22]

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[17] *See, e.g.*, NICOLAS PETIT, BIG TECH & THE DIGITAL ECONOMY THE MOLIGOPOLY SCENARIO 62–63 (2020) (stating that "while there is an undisputable trend toward industry concentration in the digital economy, there is also a competitive force behind it ... our analysis allows us to entertain doubts that big tech firms deserve to be considered as monopolies.").

[18] *See* Carl Shapiro, *Competition and Innovation: Did Arrow Hit the Bull's Eye? in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY REVISITED 367 (2012) (noting that, as concerns market structure and innovation, "general theoretical or empirical findings about these relationships remain elusive").

[19] *See* Philippe Aghion at al., *Competition and Innovation: An Inverted-U Relationship*, 120 Q. J. ECON. 701 (2005); Michael R. Peneder & Martin Woerter, *Competition, R&D and Innovation: Testing the Inverted-U in a Simultaneous System*, 24 J. OF EVOLUTIONARY ECON. 653 (2014) (Switzerland); Michiyuki Yagi & Shunsuke Managi, *Competition and Innovation: An inverted-U relationship using Japanese industry data*, Discussion Papers 13062, Research Institute of Economy, Trade and Industry (RIETI) (2013) (Japan); Michael Polder & Erik Veldhuizen, *Innovation and Competition in the Netherlands: Testing the Inverted-U for Industries and Firms*, 12 J. of IND. COMPETITION AND TRADE 67 (2012) (Netherlands); Chiara Peroni & Ivete Gomes Ferreira, *Market competition and innovation in Luxembourg*, 12 J. OF IND, COMPETITION AND TRADE 93 (2012) (Luxembourg).

[20] *See, e.g.*, Spencer Yongwook Kwon, Yueren Ma, Kaspar Zimmerman, *100 Years of Rising Corporate Concentration*, SAFE Working Paper No. #359 (2023); David Autor et al., *Foreign competition and domestic innovation: Evidence from US patents*, 2 AMER. ECON REV. 357 (2020); Aamir Rafique Hashmi, *Competition and Innovation: The Inverted U Relationship Revisited*, 95 THE REVIEW OF ECONOMICS AND STATISTICS 1653 (2013).

[21] *See* EDITH T. PENROSE, THE THEORY OF THE GROWTH OF THE FIRM (1959).

[22] David J. Teece, Gary Pisano & Amy Shuen, *Dynamic Capabilities and Strategic Management*, 18 STRATEGIC MANAGEMENT JOURNAL 509 (1997) ("Our approach is especially relevant in a Schumpeterian world of innovation-based competition").

Innovation can also be barred by diseconomies of scope.[23] That is, firms may find that in working to create a new product they are forced to move away from supporting existing products. For example, in launching personal computing, IBM was forced to divert resources away from its existing mainframe business and towards PCs, and a similar story holds true with Microsoft as it tried to expand into the browser market.[24] Indeed, in both cases, diseconomies and the inertia they created hindered the firms' ability to lead the next round of Schumpeterian competition—not as "a function of any market distortion or any disequilibrium, but are, rather, a systematic factor in many Schumpeterian waves." [25] To economize upon these diseconomies, as well as fund R&D, strategic divestitures can thus be a rational strategy for firms seeking to compete through creative destruction.

A STRUCTURAL PRESUMPTION WITH A SCHUMPETERIAN PROVISO

In *Brown Shoe Co. v. United States*, the Supreme Court explained that Congress intended a merger's competitive effects under Clayton §7 to be assessed "functionally" and "in the context of its particular industry."[26] It noted as factors for courts to consider both "whether the consolidation was to take place in an industry that was fragmented rather than concentrated," as well as whether the market "had seen a recent trend toward domination by a few leaders or had remained fairly consistent in its distribution of market shares among the participating companies."[27]

In *Philadelphia National Bank*, the Supreme Court explained the interplay of these two factors when formulating its structural presumption. As the Court explained, "[t]his intense congressional concern with the trend toward concentration warrants dispensing, in certain cases, with elaborate proof of market structure, market behavior, or probable anticompetitive effects."[28] That is, when such a trend toward concentration exists, "a merger which produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in that market, is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive effect."[29]

In *United States v. General Dynamics*, however, the Supreme Court made clear that a trend toward concentration did not always open the door to a structural presumption, and specifically how in that case the government's evidence of market shares was "insufficient to sustain its case."[30] As the lower court had found, there the increased industry concentration "occurred not because small producers have been acquired by

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[23] Timothy F. Bresnahan, Shane Greenstein, & Rebecca M. Henderson, *Schumpeterian Competition and Diseconomies of Scope: Illustrations From the Histories of Microsoft and IBM in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY REVISITED 203 (2012).

[24] *Id.*

[25] *Id.* at 205.

[26] 370 U.S. 294, 322 (1962).

[27] *Id.*

[28] 374 U.S. 321, 363 (1963).

[29] *Id.*

[30] 415 U.S. 486, 501 (1974).

others," but rather as "the inevitable result of the change in the nature of demand for coal," such that the facts presented "a very different situation from that in such cases as *United States v. Philadelphia National Bank*, 374 U. S. 321 (1963), and *United States v. Von's Grocery Co*., 384 U. S. 270 (1966)."[31]

The Supreme Court agreed. As the Court explained, because concentration was driven by "fundamental changes in the structure of the market for coal" the use of market shares was of "considerably less significance" than in the grocery and brewing markets respectively at issue in *Von's Grocery* and *United States v. Pabst Brewing Co. et al.*,[32] which were not characterized by similar dynamism.[33] Specifically, the Court noted how "coal had become increasingly less able to compete with other sources of energy in many segments of the energy market" such as "oil, natural gas, nuclear energy, and geothermal power,"[34] which incentivized long run requirements contracts in a way that facilitated investment in new mining capacity.

The upshot is clear: in cases where a trend toward concentration is the result of fundamental changes in the structure of the market driven by dynamic forces like drastic Schumpeterian competition or changes in product and process technology with a corresponding need for investment, the shortcut offered by the structural presumption is not a legitimate means of satisfying the government's *prima facie* burden. Indeed, exceptions from presumptions of illegality to protect innovation are much more so the rule—not the exception—across antitrust jurisprudence. For example, under Section 1 of the Sherman Act, concerted action is not a candidate to be *per se* unlawful under the rule of reason if it creates a new product.[35] Similarly, under Section 2, predatory conduct through innovation, as opposed to that involving static dimensionalities like price, is typically found unlawful only if it is deemed a sham or otherwise pretextual.[36]

THE DRAFT MERGER GUIDELINES RISK CHILLING INNOVATION

The understanding that antitrust policy should promote innovation competition is both bipartisan and longstanding.[37] The Draft Merger Guidelines, if put into force, unfortunately risk doing just the opposite. First, and crucially, in their limited treatment of innovation, the Draft Merger Guidelines note only that "competition between firms may lead them to make greater efforts to offer a variety of products and features," such that a merger can create a "reduced incentive to continue or initiate development of new products that

[31] *Id.* at 492–93 (citing 341 F. Supp. 534, at 558).

[32] 384 U.S. 546 (1966).

[33] 415 U.S. at 501.

[34] *Id.* at 491, 499.

[35] Broadcast Music, Inc. v. Columbia Broadcasting System, Inc., 441 U.S. 1 (1979).

[36] *See, e.g.*, Allied Orthopedic Appliance Inc. v. Tyco Health Care Group LP, 592 F.3d 991 (9th Cir. 2010); Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263, 287 (2d Cir. 1979).

[37] *See, e.g.*, Renata B. Hesse, Principal Deputy Assistant Attorney General, U.S. Dep't of Justice Antitrust Div., Remarks at Global Competition Review Live 5th Annual Antitrust Law Leaders Forum, Antitrust: Helping Drive the Innovation Economy (Feb. 5, 2016); Timothy J. Muris, Chairman, Fed. Trade Comm'n, Competition and Intellectual Property Policy: The Way Ahead, Before American Bar Association Antitrust Section, Fall Forum at 2 (Nov. 15, 2001).

would have competed with the other merging party, but post-merger would 'cannibalize' what would be its sales."[38]

Conspicuously absent from this discussion is any recognition of how mergers can facilitate innovation, including by enhancing the ability for appropriation, increasing scope and scale, and supporting investment in R&D—that is, basic themes of Schumpeterian competition. Although the Draft Merger Guidelines acknowledge that "[d]evelopment of new features depends on having the appropriate expertise and resources," the only inference they draw is that a merger between two such firms "with specialized employees, development facilities, intellectual property, or research projects in a particular area" can harm competition by reducing innovation—and not that a merger can increase innovation by creating "the appropriate expertise and resources" to foster dynamic competition.[39]

This seemingly one-sided perspective that increased product market competition leads to increased innovation is, from an economic standpoint, far more fanciful than any of the presuppositions from the oft-criticized Chicago School that made their way into antitrust policy. As we have seen, the empirical literature is clear that Schumpeterian competition matters: decreased market concentration does not mean increased innovation competition.[40] What is more, the Draft Merger Guidelines' discussion of innovation arguably betrays a focus on market structure that is at least every bit as narrow as what Agency leadership has criticized as the existing approach's singular attachment to price effects.[41]

By way of comparison, the discussion of innovation in the Draft Merger Guidelines is clearly a significant departure from that of the 2010 Horizontal Merger Guidelines. In the latter, the Agencies made clear that a merger may "enable innovation that would not otherwise take place"[42]—in other words, a general appreciation of the Schumpeterian competition that the Draft Merger Guidelines ignore. Moreover, the 2010 Guidelines also recognize that merger efficiencies can take the form of "new products," and thus clearly contemplate merging parties offering dynamic justifications for their deals.[43] By contrast, in the Draft Merger Guidelines, there is no express recognition of the role dynamic efficiencies can play in justifying a merger.

This underlying flawed and incomplete understanding of innovation is, regrettably, manifest throughout the Draft Merger Guidelines. To begin, the Draft Merger Guidelines fail to properly incorporate the significance

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[38] DRAFT MERGER GUIDELINES, *supra* note 8, at Appendix 2.E.

[39] *Id.*

[40] *See* RICHARD J. GILBERT, INNOVATION MATTERS: COMPETITION POLICY FOR THE HIGH-TECHNOLOGY ECONOMY 136 (2020) ("Antitrust enforcers often presume that mergers that substantially lessen competition in a high-tech industry are likely to harm innovation. Unfortunately, there is little empirical research that proves this assumption.").

[41] *See, e.g.*, Jonathan Kanter, Assistant Attorney Gen., U.S. Dep't of Justice, Antitrust Div., Assistant Attorney General Jonathan Kanter Delivers Remarks at New York City Bar Association's Milton Handler Lecture (May 18, 2022) ("The irony of the consumer welfare standard is that consumers have been harmed in its name by underenforcement of the antitrust laws. In practice, self-imposed requirements that the agencies demonstrate precise price effects before taking action have systematically biased us toward underenforcement.").

[42] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 23 (2010).

[43] *Id.* at 29.

of finding that an industry exhibited a trend toward concentration both as concerns the government's *prima facie* case and the merging parties' defenses. Indeed, Guideline 8 as proposed is itself superfluous, as it states that, "[i]f a merger occurs during a trend toward concentration, the Agencies examine whether further consolidation may substantially lessen competition or tend to create a monopoly."[44] But this is meaningless, as the Agencies always evaluate whether the merger may substantially lessen competition or tend to create a monopoly—regardless of whether there is a trend toward concentration.

Concerning the government's *prima facie* case, as we have seen, the relevance of a trend toward concentration is not that any merger which furthers a trend toward concentration is unlawful, but an invitation to ask whether the heightened scrutiny of a structural presumption is sufficient to make out a *prima facie* case of anticompetitive harm. But Guideline 8 does not make that clear. Moreover, and most importantly, Guideline 8 does not distinguish, as *General Dynamics* requires, between trends toward concentration that can in theory support the application of a structural presumption—such as the patterns of consolidation in cases like *Philadelphia National Bank* and *Von's Grocery*—and those that do not support a structural presumption—such as the "fundamental changes" involving Schumpeterian competition and technological change in *General Dynamics*.

The failure to make this distinction is exacerbated by the Draft Merger Guidelines' use of the trend toward concentration factor in precluding an efficiencies defense. Specifically, the Draft Merger Guidelines state—without case support—that Guideline 8 will be used to preclude efficiencies defenses that "accelerate a trend toward concentration."[45] But because such trends to concentration can themselves reflect the very sort of innovation and dynamic efficiencies that typify Schumpeterian competition, and which the Supreme Court in *General Dynamics* saw as distinct from the sort of trends toward concentration indicative of anticompetitive activity, the standard set forth in Guideline 8 will not just unreasonably limit efficiencies defenses generally, but have a uniquely detrimental chilling effect on dynamic efficiencies.

That is, not only has it been long understood that deconcentrated market structures are simply not dispositive as to static consumer welfare effects,[46] but market concentration is inherent in the Schumpeterian process of innovation competition and dynamic efficiencies. At bottom, the Agencies must not overemphasize *Brown Shoe's* recognition of the relevance that a trend toward concentration may have in certain cases to the exclusion of its more fundamental propositions that merger enforcement is about the "protection of competition, not competitors," and must not overlook "the stimulation to competition that might flow from particular mergers,"[47] including through dynamic efficiencies.

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[44] DRAFT MERGER GUIDELINES, *supra* note 8, at 4.

[45] *Id.* at 34.

[46] As concerns the static case, the problems with the simple concentration doctrine an structure-conduct-performance paradigm have also been long understood. *See, e.g.*, Harold Demsetz, *Industry Structure, Market Rivalry, and Public Policy*, 16 J.L. & ECON. 1 (1973); *see also* Jonathan B. Baker, *Merger Simulation in an Administrative Context*, 77 ANTITRUST L.J. 451, 456 (2011) ("[R]ules based on market shares and market concentration provide poor guidance for analyzing mergers, whether the competitive effects theory involves unilateral or coordinated effects.").

[47] Brown Shoe Co. v. United States, 370 U.S. 294, 319–20 (1962).

Second, even where a structural presumption could make sense, the thresholds in Guideline 1 are out of step with modern innovation economics. Specifically, the presumption that mergers will harm competition when they result in a change in HHI greater than 100, and either a market-wide HHI greater than 1,800 or a combined firm with a share greater than 30 percent,[48] falls well short of the point where increased concentration is likely to result in reduced innovation, which many studies in the business strategy literature have suggested occurs with approximately three equal sized firms.[49] Whereas the HHI thresholds in the 2010 Merger Guidelines are not necessarily generally inconsistent with these findings, by effectively making 6-5 mergers their marginal case, the Draft Merger Guidelines risk applying a structural presumption to a wide swath of mergers with dynamic efficiency benefits that may far outweigh any static harms.

By virtue of singling out platform markets, Guideline 10 is also problematic. While the Draft Merger Guidelines purport to protect "competition to *displace* the platform," Guideline 10 suggests that mergers in platform markets raise a greater risk of harm to competition than in non-platform markets, presumably by virtue of network effects that "can create a tendency toward concentration in platform industries."[50] However, the existence of network effects is no guarantee of "winner-take-all" or "tipping" toward dominance, with many platform markets being characterized by multi-homing strategies—which increases competition in the market.[51]

Moreover, rather than constitute a trend toward concentration like that in *Philadelphia National Bank* as a factual predicate for a structural presumption, courts have recognized how network effects are inherent in platforms and create value for consumers: the more persons on a platform, the more valuable that platform ultimately becomes to each of them.[52] As such, concentration driven by network effects are analogous to the trends driving concentration in *General Dynamics* that concerned the "nature of demand" in the market and did not warrant application of a structural presumption.[53] And, to be sure, while such network effects can also

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[48] DRAFT MERGER GUIDELINES, *supra* note 8, at 7.

[49] *See, e.g.*, JAGDISH SHETH, CAN USLAY & RAJENDRA SISODIA, THE GLOBAL RULE OF THREE: COMPETING WITH CONSCIOUS STRATEGY (2020); Adam Thierer, *The Rule Of Three: The Nature of Competition In The Digital Economy*, MERCATUS (July 2, 2012); Can Uslay, Z. Ayca Altintig, & Robert D. Windsor, *An Empirical Examination of the "Rule of Three": Strategy Implications for Top Management, Marketers, and Investors*, 74 J. of Marketing 20 (2010). Indeed, such findings are consistent with recent agency investigations concerning innovation. *See, e.g.,* Randy C. Chugh at al., *Economics at the Antitrust Division 2015–2016: Household Appliances, Oil Field Services, and Airport Slots*, 49 REV. IND. ORGAN. 535, 546 (2016) (noting the Division's findings in the Haliburton/Baker Hughes that ''only the Big Three are serious participants in this market because of the breadth of their product lines, their ability to integrate products and services, the quality of their reservoir data, and their capacity to conduct the necessary R&D" and describing how "persistent innovation leadership of the Big 3 is supported by their scale and scope').

[50] DRAFT MERGER GUIDELINES, *supra* note 8, at 23.

[51] *See, e.g.,* Jean-Charles Rochet & Jean Tirole, *Platform Competition in Two-Sided Markets*, 1 J. EUR. ECON. ASS'N 990, 991-94 (2003); see also Catherine Tucker, *Network Effects and Market Power: What Have We Learned in the Last Decade*, 32 ANTITRUST 72, 75-76 (2018); *see also* DAVID EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING 146–47 (2005) ("Multi-homing is common in many multisided industries")

[52] *See, e.g.*, U.S. v. Microsoft, 253 F.3d 34, 49 (D.C. Cir. 2001).

[53] 415 U.S. 486, 493 (1974).

constitute barriers to entry, special treatment within the Draft Merger Guidelines is plainly not warranted, as concerns about network driven barriers to entry are already cognizable within current merger analysis as viewed by both courts[54] and the 2010 Horizontal Merger Guidelines.[55]

The Draft Merger Guidelines' treatment of platform markets is made worse by its discussion of the burden that the Agencies will face in challenging a merger on the grounds that it will harm innovation, which is relegated to Appendices. While the Agencies can challenge mergers between firms engaged in rival R&D and a "race to the market" that may result in a substantial lessening of competition,[56] the Guidelines go further and state that the Agencies may "define relevant antitrust markets around the products that would result from that innovation, even if they do not exist."[57] As distinct from R&D markets, this seeming contemplation of future product markets divorced from any R&D is contrary to both common sense and case law.[58]

Moreover, the Draft Merger Guidelines appear to overlook important limitations that should apply when alleging harm to R&D or innovation. The first involves the use of structural evidence. As we have seen, and contrary to the approach of the Draft Merger Guidelines, there is no general relationship between deconcentrated market structures and innovation, making structural evidence showing that the merger will result in increased concentration irrelevant in innovation markets' cases. As Chairman Muris explained in *Genzyme/Novazyme*, there is simply no basis for "an inference regarding the merger's likely effect on innovation (and hence patient welfare) based simply on observing how the merger changed the number of independent R&D programs."[59]

Second, *Genzyme/Novazyme* also demonstrates the difficulty in alleging harm to innovation, even in a well-defined R&D market, when one of the merging parties is essentially only a potential competitor.[60] That is, the concomitant use of innovation markets *and* the potential competition doctrines to challenge a merger layers potentiality upon potentiality. To bring such challenges would thus be in tension with *Brown Shoe's*

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[54] *See, e.g.*, U.S. v. Bazaarvoice, Case No. 13-cv-00133-WHO (N.D. Cal. Jan. 8, 2014) at 94 ("The feedback between manufacturers and retailers creates a network effect that is a significant and durable competitive advantage for Bazaarvoice.").

[55] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 6 (2010).

[56] *See* Press Release, U.S. Dep't of Justice, Antitrust Div., Applied Materials Inc. and Tokyo Electron Ltd. Abandon Merger Plans After Justice Department Rejected Their Proposed Remedy (April 27, 2015); Statement of the Federal Trade Commission in the Matter of Nielsen Holdings N.V. and Arbitron Inc., File No. 131-0058 (Sept. 20, 2013).

[57] DRAFT MERGER GUIDELINES, *supra* note 8, at Appendix 3.B.7.

[58] *See, e.g.*, SCM Corp. v. Xerox Corp., 645 F.2d 1195 (2d Cir. 1981); Fraser v. Major League Soccer, LLC, 97 F. Supp. 2d 130, 140-41 (D. Mass. 2000), *aff'd*, 284 F.3d 47, 71 (1st Cir. 2002).

[59] Timothy J. Muris, Chairman, Fed. Trade Comm'n, Statement In the Matter of Genzyme Corporation/Novazyme Pharmaceuticals, Inc. 6 (Jan. 13, 2004) (declining to challenge acquisition of a perceived potential competitor in an innovation market).

[60] *Id.* (noting that "Genzyme also stated that the promise of the Novazyme technology was to provide a basis for an improved second-generation therapy").

instruction that while the Clayton Act deals with "probabilities, not certainties," there is no statute "for dealing with ephemeral possibilities."[61]

Indeed, the Draft Merger Guidelines' discussion of the potential competition doctrines is by itself concerning. Specifically, in discussing the actual potential competition doctrine, the Draft Merger Guidelines state that "[i]f the merging firm had a reasonable probability of entering the concentrated relevant market, the Agencies will usually presume that the resulting deconcentration and other benefits that would have resulted from its entry would be competitively significant."[62] Not only does this appear to be inconsistent with case law,[63] but as discussed above, such a presumption of sufficiency is plainly inconsistent with the uncertainty firms often face when embarking on a course of dynamic entry and will chill procompetitive mergers that may be necessary to allow such technologies to reach sufficient scale and ultimately diffuse throughout the market.

A presumption of sufficiency for purposes of applying the actual potential competition doctrine also creates a blatant inconsistency in the Draft Merger Guidelines. For purposes of showing entry and repositioning to rebut a *prima facie* case, the Draft Merger Guidelines require the merging parties to *prove* sufficiency, as "the prospect of entry may not effectively prevent a merger from threatening a substantial lessening of competition."[64] But the conditions for showing procompetitive entry should not vary depending on whether they benefit the government or the merger parties, and the Draft Merger Guidelines nowhere explain why this double standard is applied—either from economics or case law.

RECOMMENDATIONS

For these reasons, ITIF has significant concerns about the Draft Merger Guidelines and offers the following recommendations:

- **Reassess the justification for new guidelines:** The 2010 Merger Guidelines appear to be superior to the Draft Merger Guidelines from the standpoint of promoting innovation. Crucially, the 2010 Merger Guidelines acknowledge that mergers can foster dynamic competition and the creation of new products. Moreover, while they recognize that consolidation can also reduce innovation, the 2010 Merger Guidelines deploy structural thresholds that are generally not inconsistent with the economic evidence concerning the relationship between market concentration and innovation.
- **Recognize that Schumpeterian competition drives innovation and consumer welfare:** The Agencies' desire for new merger guidelines that can be used to better analyze the competitive effects of mergers in New Economy markets is belied by the terse and fundamentally incomplete discussion of innovation in the Draft Merger Guidelines—both as a theory of anticompetitive harm and to ensure that mergers which enhance innovation are not chilled through overenforcement. Most

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[61] Brown Shoe Co. v. United States, 370 U.S. 294, 323 (1962).

[62] DRAFT MERGER GUIDELINES, *supra* note 8, at 12.

[63] As opposed to a "reasonable likelihood" of entry, case law suggests that a probability standard applies. *See, e.g.*, Fed. Trade Comm'n v. Steris Corp., 133 F. Supp. 3d 962, 966 (N.D. Ohio 2015) (asking whether Steris "probably" would have entered the U.S. contract sterilization market).

[64] DRAFT MERGER GUIDELINES, *supra* note 8, at 33.

importantly, any revised Draft Merger Guidelines must include a comprehensive treatment of innovation that includes an unambiguous recognition of the fundamental role played by Schumpeterian competition in empowering innovation and consumer welfare.

- **Add a Schumpeterian proviso:** The Draft Merger Guidelines overlook case law and economics by failing to disclaim the application of a structural presumption in markets, such as those in *General Dynamics*, that are typified by dynamic forces or Schumpeterian competition. Indeed, this defect is exacerbated by the lower concentration thresholds that will presume unlawful many mergers that could improve dynamic efficiency in ways that exceed any static harms. To the extent the Agencies proceed with new guidelines, they must at the very least abandon these new concentration thresholds or make clear that a structural presumption is inapposite in markets that prominently feature Schumpeterian dynamics and innovation competition. Doing both would be even better.

CONCLUSION

To carry out its legal mandate to protect "competition, not competitors," the Draft Merger Guidelines must not only "recognize[] the stimulation to competition that might flow from particular mergers," but in determining whether a merger may substantially lessen competition or tend to create a monopoly, assess a merger "functionally" and in "the context of its particular industry."[65] Unfortunately, the Draft Merger Guidelines fundamentally fail to recognize the Schumpeterian nature of competition that characterizes many industries in the modern economy. Not only are its revised concentration thresholds in irreconcilable tension with the economic evidence surrounding the relationship between market structure and innovation, but established antitrust law counsels against the use of a structural presumption to satisfy the government's *prima facie* burden in markets characterized by the Schumpeterian competition—a dynamic process that continues to empower the technological progress and economic growth that will safeguard American democracy and global leadership in the 21st century.

Thank you for your consideration.

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[65] Brown Shoe Co. v. United States, 370 U.S. 294, 319–20 (1962).