DIGITAL BREXIT

The implications of different digital regulation in the EU and the UK

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THE IMPLICATIONS OF DIFFERENT DIGITAL REGULATION IN THE EU AND THE UK

Last December, the European Commission (EC) published a proposal for a Regulation on "contestable and fair markets in the digital sector" (the Digital Markets Act or DMA) and the Competition and Markets Authority (CMA) issued its advice to the UK government on a "new pro-competition regime for digital markets".

The CMA's advice is less detailed and specific than the EC's, given its status as a set of recommendations rather than an official proposal for a regulation. However, at this stage, it appears that the two approaches could generate a material regulatory divergence between the UK and the EU.

To summarise, the proposed EC regulation lists a series of do's and don'ts with which large digital firms (measured in terms of revenues, market capitalisation and user base) will have to comply. Some of these rules (Article 5) are self-executing and aim at ensuring that users/businesses are free to minimise their use of gatekeeper platforms. Others (Article 6) are focused on establishing a level playing field, via measures relating to self-preferencing, interoperability/switching and access to data. In order to enforce these rules, the EC will be able to conduct investigations, impose fines and, if necessary, require non-compliant firms to implement behavioural or structural remedies.

The specific requirements in the CMA's proposed code of conduct are unclear at this stage (currently, we know only the high-level principles). However, these will be tailored to the circumstances of each individual firm with Strategic Market Status (SMS) rather than the one-size-fits-all approach of the EC. In addition, the newly created Digital Markets Unit (DMU) within the CMA is proposed to be able to impose so-called pro-competitive interventions (PCIs) and to review acquisitions by SMS firms that are currently not subject to merger control. These measures have the objective of changing existing levels of competition, rather than simply preventing additional competition issues.

Given these differences between the two proposed regimes, there is the risk of a potential "Digital Brexit". Global platforms, facing different regimes in the EU and UK, may tailor their offerings differently in each area. In particular, given the apparently more intrusive and unpredictable regulation in the UK, firms with SMS status may be more cautious about innovating and introducing new products in UK, given that it is unclear how the DMU may respond (compared to the more predictable EC regime). There will certainly be an increased regulatory risk for firms overall if the proposals are implemented in their current diverging forms.

DMA VS DMU: COMPARE AND CONTRAST

PRAGMATISM IN THE FACE OF COMPLEXITY

Both the CMA and the EC acknowledge the extreme complexity of digital markets as well as the rapidity with which the industry develops and innovates. As a result, both authorities are planning to build up their knowledge and expertise in these markets, and they will seek to adapt their approach to regulation to the specificities of these sectors.

Unlike other regulated industries, such as telecoms, both proposals move away from designing interventions on the basis of market definition. Instead, they suggest focusing on large firms (in terms of revenue and user basis) providing defined specific digital services (tellingly, the list of in-scope services is quite similar in both proposals). In this way they bypass the complexities of formal market definition exercises. Whilst this appears to be a pragmatic solution to the challenges of defining markets with two-sided market platforms, it also gives rise to some conceptual oddities. For instance, the CMA proposes that the DMU will identify SMS on the basis of "entrenched market power". It is unclear how one can measure market power without having gone through a market definition exercise.

Both authorities also recognise the benefits generated by digital businesses. They highlight the importance of cooperation and open communication with firms to design and implement effective regulation[1] that does not lead to greater costs than benefits and that addresses potentially problematic conducts and outcomes.

Moreover, whilst the global public debate that preceded the publication of these proposals has focused on the need for breaking up big players in digital markets, the EC and the CMA clearly consider full ownership separation as a measure of last resort. Both focus on regulation to remedy specific potential issues rather than throwing the baby out with the bathwater.

PREVENTION OR CURE?

The key concerns and market characteristics addressed by both proposals relate to the perception that the relevant firms have a high degree of market power. As discussed in our outlook for 2021, the DMA's focus is on defining the "rules of the road" for digital gatekeepers to follow, with the aim of ensuring that these markets are contestable and the gatekeepers can be challenged. By comparison, the DMU's core concern seems to be the presence of SMS firms themselves – in particular, by proactively addressing their "root cause of market power".

In other words, the key question that the EC is trying to answer with the DMA is this: given that certain market characteristics generate large players with market power, how do we make sure that this power doesn't harm consumers and innovation, for example through leverage into adjacent markets? Conversely, the CMA seems to have started from a different question: how do we reduce the market power that certain firms have gained over time?

This different conceptual approach is then reflected in most of the respective proposals and, in the near future, might translate in tougher investigations and pro-active interventions by the CMA in the relevant aspects of the digital industry.

[1] E.g. "The objective of the proposal is therefore to allow platforms to unlock their full potential [and] to allow end users and business users alike to reap the full benefits of the platform economy and the digital economy at large" (EC, page 2-3); "'In this chapter, we briefly outline the huge importance of digital markets, both to consumers, businesses and the economy" (CMA, para 2.1 and 2.2); and , "the DMU should seek to resolve concerns using a participative approach, engaging with parties to deliver fast and effective resolution" (CMA, recommendation 7.b).

DEEP AND NARROW, OR WIDE AND SHALLOW?

In principle, both proposals for ex-ante rules (or codes of conduct) target only firms operating in the digital sector[2] with large revenues and user base[3] and with "entrenched" market power[4]. However, there are clear differences between the two.

The CMA's scope of ex-ante rules seems to be more targeted - focused on a small number of large digital firms, and far-reaching – with potentially significant impacts on their operations and business models. (Note, however, that it is currently unclear exactly how the SMS concept will be defined and implemented.) Conversely, more firms would likely fall within the scope of the DMA and it appears less interventionist[5].

These differences are consistent with the apparent divergent philosophies discussed above. The upshot might be that the few firms targeted by the CMA regime will face significant regulatory challenges in their UK operations, whilst in the EU a larger number of large digital firms will need to change the way they behave. The GAFAs are clearly targeted under both proposals.

Further regulatory challenges could arise from the timing of the introduction of codes of conduct or PCIs implemented by the DMU. For example, Google competes with Facebook in digital advertising and with Apple in the market for mobile operating systems. Any misalignment in the timing of interventions targeting two large firms operating in the same (or adjacent) market(s), might create material distortions to competition.

DISCRETION OR RULES?

The DMA outlines a pre-determined set of ex-ante rules that gatekeepers must satisfy and establishes that the EC can extend these rules only by: (a) specifying further the principles set out in Article 6; and (b) adding firms and activities to the scope of the regulation (through time-consuming changes to legislation), ex Article 17.

The EC also proposes having somewhat restricted powers to impose broader remedies than those arising from breaches of specific DMA prohibitions. In fact, it can impose additional remedies only if two conditions are met, ex Article 16(1): "the gatekeeper has systematically (at least three non-compliance or fining decisions in five years) infringed the ex-ante rules laid down in Articles 5 and 6"; and "it has further strengthened or extended its gatekeeper position".

Furthermore, the DMA allows the EC to impose structural remedies, but these are limited to repeat offenders which have shown systematic non-compliance over an extended period, and specifically where "there is no equally effective behavioural remedy or where any equally effective behavioural remedy would be more burdensome"[6].

In contrast, the CMA's proposal suggests that Parliament legislate only on the high-level objectives of the code of conduct and leave the DMU free to determine the practical guidance on interpreting them ("how principles should be interpreted") and in turn which obligations should firms face ("how firms should behave")[7].

[2] Definition of core platform service (EC, Article 2.2) and digital activity (CMA, Recommendation 3a)

[3] Revenue and user number thresholds are set out by the EC in Article 3 and by the CMA in para 4.19

[4] Both the SMS concept in the UK and the gatekeeper concept in the EU refer to the adjective "entrenched" (EC, Article 3(1(c)); CMA, Recommendation 3a).

[5] The DMA's gatekeeper criteria are based primarily on absolute size rather than market power so a potentially wide range of digital firms could fall within scope

[6] EC, Article 16(2)

[7] CMA, Recommendation 4b and para 4.35

Based on the current proposals, it appears that the CMA will have much more room for manoeuvre in imposing potentially extensive remedies through implementing its PCIs. In fact, the CMA asserts that it will "not be limited in the types of remedies it is able to apply"[8], it "should be able to implement PCIs anywhere within an SMS firm"[9] and the limit proposed for PCIs is to be targeted to "rectify an adverse effect on competition or consumers" and to be "likely to be effective and proportionate"[10].

This highly flexible framework (when compared with the more rigid, rule-based approach proposed by the EC) might generate material challenges in terms of clarity and legal certainty. For example, the principles of fair trading, open choices, trust and transparency proposed by the CMA could be interpreted in a variety of ways. Similarly, the notion of "services" to which these principles should be applied[11] lacks sufficient clarity in light of the complexities of two-sided platforms: for instance, is Google providing a search service or a search service with an advertising service? This apparently subtle distinction could change dramatically the way in which the principles proposed by the CMA will be applied.

Lastly, even if PCIs no make the final cut following the legislative process, the CMA would retain the significant powers already available to it through its market investigations regime, which would enable it to impose new and potentially significant remedies in digital markets on an ongoing basis.

UNAPPEALING

The penalties systems proposed by the CMA and the EC are both broadly aligned with the current antitrust regime: "not exceeding 10% of its total turnover in the preceding financial year" for violations of rules, interim measures or remedies and 1% for providing misleading information[12]. Fines could clearly be very large given the size of the firms in question. Guidance will be necessary to understand how these fining powers will be applied in practice, given that the same caps appear to apply to both short-term technical breaches and long-term blatantly anti-competitive activity.

However, whilst the fining powers are similar, the proposed appeal procedures differ. EC decisions and penalties based on the DMA will be subject to similar review processes as merger control decisions and antitrust cases[13]. However, the CMA proposes that "the DMU's decisions should be judicially reviewable on ordinary judicial review principles and the appeals process should deliver robust outcomes at pace[14]".

While the CMA would obviously prefer to have a less stringent standard of review, this would conflict with the approach currently taken in relation to antitrust cases, where a merits review is required. Since the potential fines are comparable, it might seem sensible to maintain a similar standard of appeal.

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Both the EC and the CMA propose to introduce compulsory reporting of any acquisition made by large digital firms with gatekeeper/SMS status. However, once again, there are significant differences.

[8] With the exception of ownership separation (CMA, Recommendation 6a)

[9] CMA, Recommendation 6b

[10] CMA, para 4.76 and 4.77

[11] CMA, para 4.38

[12] EC, Article 26 and CMA Recommendation 7.c and para 4.96

[13] The Court of Justice can review the legality of legislative acts and acts of the Commission other than recommendations and opinions, ex-Article 263 TFEU, and has unlimited jurisdiction with regard to the penalties, ex-Article 261 TFEU.

[14] CMA, Recommendation 9d

The EC will not review the merger but only assess if new firms/activities need to be included in the DMA and use the information gathered in these transactions to learn more about the markets affected and the sector as a whole[15].

Conversely, the CMA proposes that the DMU will be able to review the reported mergers, to apply a lower and more cautious standard of proof (a 'realistic prospect' that a merger gives rise to an SLC, rather than a more-likely-than-not test[16]) and to impose a mandatory suspension above a certain threshold (probably in relation to transaction value)[17].

This divergence in merger control is likely to have two main effects, depending on the case:

- First, some transactions might lead to the carve-outs of the UK divisions of certain businesses and/or the cessation of certain activities and services in the UK.

- Second, where carve-outs are not possible, the UK will become the regulatory benchmark and test ground for this type of transactions: if an acquisition can pass muster in the UK it is likely to win approval in other jurisdictions, especially given the CMA's very aggressive stance on merger control. This may lead to firms engaging earlier with the CMA, before proceeding with certain deals.

DIGITAL BREXIT?

Does this divergence in regulatory proposals augur a Digital Brexit, with the UK opting for more stringent rules than the EU? And if so, will this have any wider implications for the UK?

The UK is currently one of the most fertile environments for digital innovation and venture capital investment in technology. If the UK regulatory regime were to end up being significantly stricter and less certain than the EU's, firms might look to roll out new products outside the UK first, to test both the commercial and regulatory waters before launching them in the UK.

As well as the large tech firms directly targeted by the EC and the CMA, a Digital Brexit could also affect small and innovative start-ups. Many tech start-ups recognise that they are unlikely to grow to a mass scale, and so seek to develop their ideas to a certain level before selling to a larger firm. More stringent merger controls resulting from a Digital Brexit could limit the opportunities of such start-ups to monetise their investments, thereby prompting them to set up shop outside the UK.

This potential unintended consequence raises questions as to whether divergence from the EU in digital regulation fits with the UK government's post-Brexit objective of expanding those sectors in which the UK currently has a comparative advantage vis-a-vis the EU.

[15] EC, Article 12

[16] CMA, para 4.153

[17] CMA, Recommendation 11

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