William E. Kovacic

An Antitrust Tribute

*Liber Amicorum* - Volume II

Editors’ Note
Nicolas Charbit
Elisa Ramundo

Following the success of William E. Kovacic Liber Amicorum—Volume I published in 2012, the Institute of Competition Law is proud to release the second volume of this book within the European tradition of Liber Amicorum.

In witnessing the constant growth of antitrust regimes around the world and in recognizing the significant role played by William Kovacic in favoring the antitrust dialogue at the international level, this Volume II pays tribute to Professor Kovacic’s outstanding career offering a unique combination of theoretical insights and practical knowledge of competition and antitrust law issues worldwide.

In this Volume II, thirty-seven prominent authors signed twenty-seven contributions that tackle some of the most stimulating and current topics in competition policy and antitrust laws.

PART I, entitled “THE INTERNATIONAL DIMENSION OF COMPETITION POLICY,” includes twelve articles that offer a dynamic overview of international competition policy. Thus, Jonathan Baker reviews Kovacic’s work on the design of antitrust enforcement institutions analyzing how antitrust norms exhibit continuity over the time; Doris Hildebrand, stemming from Kovacic’s advocacy for convergence, discusses how the US/EU divide can be surpassed by superior norms; Florian Wagner-von Papp delineates a comparison between the US antitrust laws and EU competition law pointing out some thoughts on the importance of defining the relationship between antitrust law on the federal (or EU) level and antitrust laws on (Member) state level; Jacques Steenbergen offers some reflections on legitimacy, accountability and independence of competition authorities; Maureen Ohlhausen discusses the recommendations in the “FTC at 100 Report” for improving agency performance; John Briggs and Donald Baker suggest a critical revision of the US antitrust policy and administration to join the rest of the world; Marc Winerman steps into the past discussing the international issues arising when the FTC first opened its doors and even before; Bruno Lasserre highlights successes and challenges of the European Competition Network; Wouter Wils gives a retrospective
analysis of the EC Regulation 1/2013, after ten years since its enactment; Ali Nikpay tries to assess the OFT’s performance by reference to the analytical framework set down by Kovacic on agency effectiveness; Julian Peña outlines the role of international cooperation in the development of competition law in Latin America; Ian McEwin delves into the existing connection between business, politics and competition law in Southeast Asia.

The fifteen articles of PART II, entitled “COMPLEXITIES OF ANTITRUST RULES AROUND THE WORLD”, guide readers through some of the intricacies in the application of antitrust rules in different countries around the world. In Part II, John Terzaken and Molly Kelley analyze the expanding role of behavioral remedies in cartel enforcements; Damien Geradin and Laurie-Anne Grelier offer some critical considerations on the EU Directive on Antitrust Damages Claims; Omar Guerrero and Alan Ramírez explore how effective criminal cartel provisions could be to deter cartel behavior; Robert Marshall and Leslie Marx discuss compliance with Section 1 of the Sherman Act from an economic perspective; Caron Beaton Wells, drawing on the Australian experience, tests effectiveness of a range of leniency policies; Eleanor Fox and Merit Janow, by examining the Vitamin C cartel case, set forth the main points at which trade and competition ought to meet; Andy Chen analyzes impacts and implications arising from the LCD cartel case for the Taiwanese competition policy; Simon Roberts reviews the approach of the South African Competition Commission to uncovering collusion in the construction sector and draws out some lessons for establishing new institutions; Patrick Rey and Thibaud Vergé outline vertical restraints treatment in the EU; Andreas Mundt conducts an insightful digression on some forms of vertical restraints vis-à-vis the rapid development of the Internet economy; Daniel Crane provides some analytical clarity on the legal rules governing predatory innovations claims; Joseph Kattan and Chris Wood explain the standard-essential patents and the related problem of hold-up; Margaret Bloom discusses convergence and cooperation in international merger control; Joshua Wright and Jan Rybnicek advocate for a more committed consideration of the evolution of out-of-market efficiencies in the US and around the world; George Cary and Elaine Ewing consider what can the US/EU experience in the merger context tell us about convergence with MOFCOM.

Volume II, with its 27 papers, takes readers around the world providing them with provoking reflections, insightful thoughts, and learning experiences on competition policy and antitrust laws. This is the same world that Bill Kovacic has traveled so much to share knowledge and favor dialogue among different players in the international antitrust arena.

The editors would like to give their sincere thanks to the thirty-seven authors for their hours of labor in dedication to the Volume II of this Liber Amicorum and to Anna Pavlik and Jessica Rebarber for their precious editorial assistance.
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Acknowledgment

Bill Kovacic is a walking positive externality. He makes everyone around him better. We are not exceptions. After offering generous commentary about our recent book, *The Economics of Collusion: Cartels and Bidding Rings*, he strongly suggested that we mutate much of the analysis into an economics class regarding Section 1 compliance. We have recently offered a webinar in that light, which Bill hosted. This paper would not have been written without Bill’s ongoing encouragement. We are honored to coauthor with him as the opportunity presents, and honored to refer to him as our professional colleague and friend.

Abstract

Explicit collusion requires that the participating firms implement collusive structures in order to mitigate secret deviations and have a self-enforcing agreement that elevates profits. Current antitrust compliance training does not convey to product division decision-makers the difficulty of implementing collusive structures, nor does it convey that the structures will leave a trail of economic evidence in their wake. General counsels and top management should convey to product division decision-makers that they will be looking for these “tells” as part of their efforts to ensure compliance with Section 1.

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I. Introduction

It is transparent to firms in an industry that their rivalry diminishes their profits. If the firms in an industry can successfully enter into a self-enforcing agreement to suppress inter-firm rivalry, then they will enhance their profits. There are social costs to such an agreement. Transactions are not consummated that would have been in the absence of the agreement, and buyers who are unaware of the conspiracy by the sellers will still trust that competitive forces are at work to secure the best value for them. In addition, buyers will not experience meaningful price discovery—information that they would normally expect to obtain from a competitive procurement process will not be revealed. Therefore, with the view that the benefits of competition are fundamental within a market-based economy, lawmakers have intervened and made it illegal for firms to enter into agreements to suppress their rivalry. Penalties for such conduct can include jail time as well as large fines, and there can be civil litigation by buyers who were damaged by the collusion.

Nevertheless, the temptation of incremental profits from the suppression of inter-firm rivalry is large. The concern for the general counsel’s office of a large firm is ongoing. As a consequence, it is often the case that the general counsel’s office will conduct antitrust compliance training and often involve outside counsel to assist with such training. The central messages from such training are simple. First, an agreement between firms in an industry to suppress their rivalry is illegal. Second, the financial penalties can be large and the individual perpetrators can end up in jail. Third, there are leniency or amnesty programs that provide incentives for co-conspirators to report the illegal conspiracy, so you cannot trust your co-conspirators, and it is important to come clean quickly if you are doing something illegal so as to be able to take advantage of leniency. Fourth, the boundary between what is and what is not an illegal agreement is sometimes difficult to know, so the attorneys go through a number of hypotheticals to illustrate the boundary.

From our perspective, if the goal of antitrust compliance training is to try to convince product division managers that explicit collusion is not an activity that they should consider, there is a huge gap in the training. The training treats explicit collusion in the same way that one would treat an illegal unilateral activity by a division manager—you would inform decision makers that the activity is illegal, there are substantial penalties, some people who discover the activity may receive a reward for reporting the activity, and the boundaries of what is illegal and what is not illegal would be explored with hypotheticals.

The gap in the Section 1 compliance training is that the product division manager has not been educated as to the difficulties involved with the meaningful initiation and implementation of a self-enforcing agreement to successfully suppress inter-firm rivalry. They have also not been informed that there will be a wake of observable economic evidence from the implementation of an effective cartel. Adding these components to antitrust compliance can provide additional deterrence for managers contemplating illegal conduct. This is where an economist who has an understanding of explicit collusion can play an important role.
II. The Fundamental Problem —
Secret Deviations

In the absence of training regarding the economics of collusion, a division manager can fall into the following trap. They see that profits are eroded on an ongoing basis by competition with rival firms. They also see that their own performance incentive compensation is tied to the profitability of their division in the short run. Successful explicit collusion is one of few actions by which a product division manager can obtain a substantial boost in profits almost immediately. The product division manager sees competition among rival firms as the problem and the mitigation of that rivalry as the solution. What the product division manager often does not see is the difficulty of the endeavor of successful explicit collusion, especially if he or she has never attempted it before and has had no training regarding the initiation and implementation of explicit collusion. With the appeal of elevated profits, a product division manager, ignorant of the economics of collusion, may reach out to his or her counterparts at rival firms and suggest a meeting. At that meeting they may all agree that suppressing competition is good. They will all agree that elevated profits are good. And from that they may all agree “to do it.” But, a single two-hour lunch meeting by itself, with no follow-up, is likely to be ineffective at elevating prices and profits, while at the same time that meeting creates substantial antitrust exposure for all the firms whose product division managers met and entered into the agreement.

To see why this two-hour lunch meeting, by itself, with no follow-up, is likely to produce largely ineffective collusion, consider a hypothetical product for which there are three producers that are roughly of the same size. The product made by any one of them is essentially a perfect substitute for that made by each of the other two. We start from a place where the three firms are vigorously competing with one another. The price for the product is around $10 per unit. The product division managers go to lunch, agree that the price that makes them best off is $25 (maximizes profits), and that they should all now charge $25.

As they announce $25 to buyers, any one of them is sure to confront the following situation. A large buyer that has never bought from seller 1 approaches seller 1 with an offer to buy a large incremental quantity at a price of $22. Seller 1 believes they can make the sale without either seller 2 or 3 figuring out that seller 1 sold the product to the buyer. If it was profitable for seller 1 to be selling at $10, then it is certainly profitable to secretly sell incremental quantity at a price of $22. So seller 1 takes the deal, even though seller 1 is violating the collusive agreement with sellers 2 and 3. Sellers 2 and 3 are each receiving the same kinds of offers from buyers, and taking them. Although initially some buyer may have paid $25, now no incremental purchases are at $25 for the product, and seller 1 is approached by another buyer that offers to do additional business with them at a price of $17.
This process continues until we are back at $10. Given the incentives of buyers to obtain the best value, the return to a price of $10 occurs quite quickly. The collusive agreement is largely ineffective. This is a problem for collusive agreements. Namely, there is a strong incentive for each member of the collusive agreement to secretly deviate on the agreement. Without structures to mitigate secret deviations the collusion will be susceptible to secret deviations. The secret deviations will restrict the elevation of profits and there will still be a substantial antitrust liability. Teaching this primary point is absent from almost all current antitrust compliance training.

III. Collusive Structures That Mitigate Secret Deviations

Once this point has been conveyed, the next step is to describe the structures that are needed for explicit collusion to be profitable, namely, the structures that are needed to largely avert or mitigate secret deviations by members of the cartel. These structures fall into three general categories—pricing structures, allocation structures, and enforcement structures—although there can be overlap, with certain cartel conduct playing multiple roles. The initiation phase of price-fixing conspiracies often begins with an agreement about structures, although often the structures are refined through trial and error as the collusion is implemented. The specifics of these structures depend on the product, market, and industry. There is no “velour sweatpants” model for the structures that are needed for effective collusion.

Pricing structures refer to the coordinated elevation of prices, the coordinated restriction of quantities, and the alterations to the incentives of the sales forces within each cartel firm to implement the higher prices and restricted quantities. With regard to the first two elements, these are just the movements up a product demand curve. Again, implementation is specific to a product, market, and industry. What works well for a cartel involving one product, market, and industry may not work for another.

Cost increases and positive demand shocks are legitimate barometric forces that cause prices to rise in an oligopolistic industry. A cartel will increase prices beyond what these barometric market forces would produce when the firms act unilaterally. Cartel firms may orchestrate elevated bids for the procurements conducted by buyers around the world. A cartel may orchestrate price announcements that are beyond what is justified by cost and demand increases, and these announcements may be directly on the heels of a trade association meeting where the cartel members assembled to agree upon the magnitude, timing, and sequence of the price announcements.

With regard to the incentives of the sales force within each cartel firm, prior to explicit collusion each firm would typically have in place incentives for their salespersons to obtain greater market share. In the pre-cartel world, as members of a given sales force pursue new customers and attempt to win customers from other firms, they would offer better value, which would often manifest itself, in part, in terms of price concessions.
Leaving these incentives in place can be problematic for effective collusion. Because a firm-wide notification that upper management has entered into a collusive agreement with competitors is unlikely, cartel firms may need to alter the sales force incentives to be “price before volume.” Specifically, the sales force would no longer be incentivized to pursue new customers with price concessions, but rather to hold the line on prices as announced by upper management and to have no strong incentives to obtain incremental market share.

Allocation structures refer to the division of the collusive gain among the cartel firms as well as redistributions that may need to occur. All members of the cartel must feel they are getting an appropriate share of the benefit from the cartel or else they will have strong incentives to deviate from the agreement. In some products, markets, and industries a global market share agreement works well. In others a geographic allocation may be best. In yet others, a customer allocation may be the right allocation scheme. Alternatively, some combination of a market share, geographic and/or customer allocations may be best, or a cartel may find other avenues for ensuring all cartel firms benefit.

Even with a collusive allocation scheme in place, it may sometimes occur that not all cartel members receive the payoff that was agreed to for them. Sometimes cartel members make unintentional mistakes. Then redistributions among cartel members may be needed. In some products, markets, and industries, these redistributions take the form of end of year “true ups” whereby a firm that has oversold its cartel market share buys enough product from a firm that has undersold its cartel market share so as to achieve the end-of-year agreed market shares for all cartel members. Other transfers can occur by inter-firm transactions at non-market prices, the settlement of lawsuits between the cartel firms regarding meaningless inter-firm contractual obligations, or a myriad of other ways by which resources can move from one firm to another.

Enforcement structures refer to the mechanisms used by cartel members to monitor one another’s compliance with the collusive agreement as well as adverse consequences for detected attempts at secret deviations. Monitoring may include both the monitoring of pricing to customers as well as the production and sale quantities of each firm. International cartels may monitor import/export statistics as to what is leaving and entering each country. In addition, surveillance of individual production facilities may occur to see what production inputs are arriving by truck or rail and what is leaving in terms of finished output. Pricing to customers may also be monitored. If attempts at secret deviations continue and are of a sufficient magnitude, the leading firms in the cartel may abandon the collusive agreement and revert to non-collusive rivalry.

It can be the case that the pricing, allocation, and enforcement structures are not ideal, or have some “leakage” in that some amount of secret deviations occur, and yet profits are still elevated relative to unilateral conduct. The ideal set of structures can move the cartel toward the eventual goal of joint monopoly profit. Weaker collusive structures will limit the profitability of the cartel, although they may still support elevated profits.

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3 Economic theory has shown that in some environments cartels can sustain elevated prices without much, if any, direct monitoring.
Agreeing on these structures in the initiation phase of a cartel, and then implementing them on an ongoing basis throughout the functioning of the cartel, requires training, dedication, and ongoing investment. After all, this is a self-enforcing agreement where no party has access to a court to resolve breach. A two-hour lunch meeting where firms agree that elevating prices is a good idea, but where there is no discussion of the structures needed to avert or mitigate secret deviations, is unlikely to generate any increase in profits. Product division managers should be taught this fundamental lesson as part of Section 1 compliance training.

IV. Collusive Structures Leave Economic Evidence in Their Wake

Once this point is in place, there is an important corollary that needs to be taught. The cartel structures will leave a trail of economic evidence revealing that a cartel is in operation. Attorneys conducting antitrust compliance training typically talk about evidence of collusion, but they typically emphasize legal direct evidence such as emails between division managers of firms in the industry that explicitly discuss anti-competitive cartel actions. The attorneys conducting the antitrust compliance training typically do not discuss the economic evidence. This evidence may be difficult to see by those outside the cartel firms, but the conduct and outcomes left in the wake of the cartel structures will be observable to the general counsel’s office and top management at each of the firms that are participating in the cartel, if they know what to look for and actively pursue the relevant information. Top management and the general counsel’s office need to convey that they will be looking for these “tells” of a cartel, and as part of antitrust compliance training, an economist needs to convey what the “tells” are that reveal the operation of a cartel.4

In isolation, parallel price increases by firms in an industry are not a “tell” of collusion. This is well recognized. Prices increase in response to standard barometric market forces throughout the economy. In isolation, increasing profits for a product division are not a “tell” of collusion. Profits can increase for any number of reasons. Furthermore, it would be unreasonable to be suspicious of division managers solely for an increase in profits. After all, that is what a firm hopes for from its division manager. In isolation, decreased capacity utilization is not a “tell” of collusion. Capacity is often idled in the face of diminished demand for a product. However, suppose that we observe all of these at the same time—increasing prices, increasing profits, and decreased capacity utilization. Jointly, these three are a strong indicator of collusion. With profits increasing, it would be a natural unilateral response by a given firm to ramp up production and try to sell as much as possible at the elevated prices and earn incremental high profits. To see a product division curtail production and sales when

4 Kovacic, supra note 1 (the strong indicators of collusion referred to as “super plus factors”).
profits are increasing leads to a strong inference of coordinated conduct as an outgrowth of the implementation of the cartel structures.

Transfers between firms in an industry are a strong “tell” of collusion. It is important to note that inter-firm transactions may occur for legitimate pro-competitive reasons. But inter-firm transfers are transactions between firms in an industry with the sole function of moving resources to resolve unintentional deviations from the collusive allocation scheme. For example, one firm may have a legitimate reason to sell a factor input to another firm, but if the transaction is done at three times the market price of the factor input then this is a transfer, not a legitimate pro-competitive transaction. Some transactions require substantial probing investigation to determine whether a transfer is a component, such as patent cross-licensing between firms, but this investigation is something that top management or the general counsel’s office can authorize and evaluate.

If one firm knows something about a competitor that the competitor would never reveal, and that could not be learned from customers or third parties but which is an important component of monitoring pricing or production/sales, then this is a strong “tell” of collusion. It is unilaterally natural for a firm to engage in acquiring market intelligence about a competitor. But it is not unilaterally natural for a firm to know about the bids that its competitors plan to submit to customers in upcoming procurements, the capacity curtailments that competitors are planning for next quarter, or what transactions occurred between competitor firms. These are all strong indicators of collusion between the firms in an industry.

Sudden changes at a point in time regarding specific conduct or incentives can be a strong “tell” of collusion. For example, if a product division announces a change in the incentives for its sales force from pursuit of market share to an emphasis on maintaining price with no incentive for obtaining incremental market share, then this is a strong “tell” of collusion. A shift in incentives to “price before volume” is not something that a firm in an industry would undertake unilaterally because doing so, while competitor firms did not shift the incentives of their sales forces, would leave the firm in a position where it continually lost market share to competitors. Thus, it is a “tell” of explicit collusion.

If no firm in the industry has a market share that exceeds 50%, then dominant firm conduct is a “tell” of collusion. It is often the case that small firms do not join a cartel but rather free-ride on the pricing umbrella created by the cartel. Sometimes the cartel does not want the smaller firms to join because it is too costly to implement certain cartel structures with regard to firms who contribute so little to the collusive gain. In such cases, the cartel, acting as a single dominant firm, may engage in predatory conduct against the smaller non-cartel firms. For example, they may deprive them of critical factor inputs. If no firm has a dominant market share, then it could not be unilateral conduct to observe a small firm deprived of factor inputs by all the large firms in the

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industry. If one large firm decided not to sell to a small firm, then other large firms would receive offers from the small firm that would be profitable, and acting unilaterally they would naturally seize the opportunity for the incremental profit. Dominant firm conduct when there is no dominant firm in an industry is a “tell” of collusion.

If the price for the product ascends to levels for which there is not valid justification in costs or demand, then this is a strong indicator of collusion. A firm is in an ideal position to have a reasonable expectation as to what current cost and demand conditions imply regarding prices for a product. A firm has access to all of the data that is necessary to construct a reasonable model of what prices should be prevailing at any point in time given unilateral conduct. If the actual price starts to greatly exceed the firm’s model for the product’s price, and there has been no event that could explain why the price movement has deviated from historical norms when conduct was unilateral, then this is a “tell” of collusion.

The next step in the instruction by the economist in the Section 1 compliance training is to note that the general counsel’s office and top management will be looking for these strong indicators of collusion, and many others like them, so if you want to engage in collusion you will need the three structures to be effective, but you will also need to avoid the wake of conduct and outcomes from the implementation of these structures. But that is a dire lesson because to avoid the conduct and outcomes that emerge from the collusive structures is to greatly encumber the effectiveness of the structures in mitigating secret deviations, which is to greatly encumber the effectiveness of any collusive enterprise. In our opinion, the economics of collusion is an essential component to effective Section 1 compliance training, and yet, to the best of our understanding, it is rarely a part of it.

V. Economists Are NOT Providing “How To” Training

Sometimes we hear the criticism that this kind of economics training is not Section 1 compliance training but, instead, “how to” training with regard to collusion. This criticism is groundless. First, consider the training that any high level executive goes through to reach their current position at a given firm. It takes years of diligent dedication to learn how to do one’s job. As individuals move along in a corporate structure, they are being groomed for the next step by upper management. No one would ever think that an individual could run the major division of a large company without substantial experience and training. So how could anyone reasonably believe that an economist’s explanation of the economics of collusion in a two-hour Section 1 compliance seminar would result in division managers being fully trained and ready to implement effective collusion? Second, without the economics training, a division manager may be under the false impression that the major hurdle to effective collusion is overcoming his timidity in suggesting to his counterparts at rival firms that they meet to discuss pricing and output restrictions. Overcoming timidity is not the major
hurdle. Implementing the collusive structures that result in effective collusion, without being detected through the trail of economic evidence left in the wake of the structures, is the major hurdle.

In conclusion, we believe that current antitrust compliance training as it pertains to Section 1 could be greatly strengthened and augmented with the involvement of economists who are versed in the issues associated with initiating and implementing effective collusion.
In the wake of William E. Kovacic Liber Amicorum - An Antitrust Tribute - Volume I, this Volume II provides, in the European tradition of Liber Amicorum, 27 contributions from 37 prominent authors spanning various antitrust topics across the world.

In this Volume II, the authors pay tribute to Bill Kovacic’s antitrust career tackling issues such as the international convergence and cooperation, agencies performance and effectiveness, cartels criminalization, vertical restraints, leniency policies, etc. Volume II sheds a light over the antitrust law world offering a unique combination of theoretical insights, practical knowledge, together with some more personal remarks on Bill Kovacic’s antitrust career.