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ROUNDTABLE ON FIDELITY REBATES

-- Note by the BIAC --

15-17 June 2016

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*More documents related to this discussion can be found at
<http://www.oecd.org/daf/competition/fidelity-rebates.htm>*

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BIAC

1. Introduction

1. An assessment of how competition agencies approach regulation and enforcement in respect of fidelity rebates needs to be put in the economic context of the impact that these rebates have: the vast majority of fidelity rebates are used by firms who do not hold substantial market power, and are implemented with the effect of reducing prices for consumers. Although fidelity rebates can be used for anticompetitive purposes in some circumstances, they normally result in benefits to consumers, and agencies should apply a strong presumption to this effect. Finding the correct approach to formulating and then enforcing rules on fidelity rebates requires competition agencies to balance the need to prevent the anticompetitive use of rebates with the need to avoid over-enforcement or ambiguities which have the ultimate effect of deterring pro-competitive price reductions. Absent a clear set of economic principles on which to base intervention in this area, enforcers should avoid acting to challenge or chill discounting practices.

2. Alongside a recognition that fidelity rebates can have an anticompetitive effect should be an acceptance that the circumstances in which they can have such an effect are limited. Under the various theories of anticompetitive harm related to the effects of fidelity rebates, the seller of a product applying the rebate needs to hold substantial market power. It should be recognized that, in the absence of such a degree of market power, the use of fidelity rebates lead to beneficial outcomes for consumers. It should also be noted that generally speaking, a consequence of this practice is that competition operates on a customer basis rather than on a “unit sale” basis, which means they will not be potentially anticompetitive unless customers representing a predominant proportion of demand are covered. A central issue, then, is how competition agencies can formulate and enforce rules which catch clearly anticompetitive rebate schemes by firms with very substantial market power, without regulatory over-reach or over-enforcement which would stifle dynamic competition, at the expense of consumers. Inextricably linked to the question of how clear, unambiguous rules can be formulated and administered is the need for convergence at the agency level. The current regulatory environment is complicated by the fact that different agencies have divergent views on dominance tests and policies on rebates, meaning that – in practice – a business attempting to put in place a global or cross-border supply agreement that incorporates price reductions must navigate a formidable number of hurdles in order to hope to be in compliance.

3. This paper examines, firstly, the distinction between procompetitive and anticompetitive fidelity rebate schemes, before assessing the most problematic aspects of current enforcement practice. The paper concludes with positive suggestions as to how agencies can proceed on enforcement of rules on fidelity rebates in a way that best protects competition, while not verging into the territory of over-enforcement.

2. Distinguishing Between “Good” and “Bad”

2.1 *Procompetitive Use of Fidelity Rebates*

4. BIAC agrees that an important first step in the examination of regulation of fidelity rebates is distinguishing between procompetitive and anticompetitive rebate schemes. Fidelity rebates (and related bundled discounts) are commonplace and are used throughout the modern economy across the world. They tend not to be complicated, convoluted devices applied by companies across the world in

an obscure way. They are frequently used by firms that have no market power. For example, a health club might offer its members one month free during an annual renewal. This type of device is obviously designed to encourage members to stick with the club and not switch their contract at the end of the contract period. Consumers in this type of scenario will, in practice, have only one health club membership.

5. The pervasive use of these types of discounts by sellers that do not possess market power implies that fidelity rebates are normally procompetitive and that they represent normal competition. One important reason for this is that the use of fidelity rebates normally promotes efficiencies. The efficiency-raising nature of fidelity rebates is widely recognized: savings in manufacturing costs, attained by enabling firms to realize scale economies; marketing efficiencies, attained by incentivizing distributors to align their sales and marketing efforts to generate greater sales of a supplier's products; transaction cost efficiencies, attained by reducing the volume of transactions and individual negotiations; and risk-sharing efficiencies (in the case of share-based discounts), attained by allowing distributors to continue to receive cost savings when their business suffers a downturn.

6. Efficiencies may be a cause or a consequence of rebates. A general way of contrasting procompetitive effects with anticompetitive ones is to check whether total output has increased or not. Pro-competitive effects of rebates, for example, may appear in the following circumstances.

7. Since rebates allow high and low demand elasticity consumers to be treated differently, elastic demand segments tend then to generate lower margins. Consumers with a high elasticity of demand benefit from the practice, although consumers with a low elasticity may suffer from it. The overall effect on consumer welfare is, thus, a priori ambiguous. But in the spirit of Ramsey pricing, in this way, rebates may also allow for the recovery of fixed costs, and thus, encourage R&D investments that involve such large fixed costs. As a result, rebates are more likely to have a procompetitive effect when high fixed costs are involved.

8. Rebates that are targeted to those consumers who are more likely to switch to competitors imply a more intense competition for these consumers. They clearly benefit from this situation. Moreover, prohibiting selective rebates as a reaction against competitive pressure may constitute excessive interventionism in the competitive strategies of firms on the part of competition authorities.

9. In a vertical relationship in particular, rebates that take the form of non-linear pricing may be used as an incentive mechanism to induce efficient behavior of retailers. For example, rebates can be used to increase retail margins on additional volumes, so as to encourage retailers to promote the product. While a uniform reduction in the wholesale price might have the same impact on retailers' incentives, it would be more costly for the supplier. Hence, rebates allow suppliers to provide incentives at a lower cost, thereby encouraging suppliers to provide more incentives and thus to compete more intensively. More generally, rebate schemes can enhance efficiency by solving adverse selection or moral hazard problems.

10. Rebates may also generate efficiency gains for the dominant firm such as economies of scale for the firm or economies of transaction costs for the customers (the buyer concentrates its purchase on a single seller).

11. Although it is sometimes suggested that rebates that take the form of pure quantity rebates are more likely to be motivated by efficiency considerations than fidelity rebates, the mere form of the rebate does not constitute a clear indicator. For instance, efficiency considerations might require personalized rebate schemes, tailored to the size of the retailer, which could take the simple form of fidelity rebates.

2.2 *Anticompetitive Use of Fidelity Rebates*

12. While the vast majority of fidelity rebates are applied by firms that do not hold substantial market power, it is widely-recognized that fidelity rebates can also under exceptional circumstances be used as tools of anticompetitive exclusion. This is accepted to be possible where a seller, which holds very substantial market power, offers discounts/rebates to customers representing a substantial share of overall demand, the discounts/rebates offered are based on purchasing activity, and the seller is able to recoup any losses associated with offering the price reductions/rebates. The key factor here is that the use of fidelity rebates in this way may have the potential to harm competition; such potentially anticompetitive use of fidelity rebates should be tackled by competition agencies.

13. Rebates can exclude actual or potential competitors from the market on which the firm is dominant. This may be the case, for instance, if the rebate is conditional on the percentage of quantities bought by the customer from the firm and the rebates are associated with predatory pricing on some of the units sold. Moreover, like predatory prices, rebates induce short-run sacrifices and may have exclusionary effects either by inducing exit or by discouraging entry.

14. Finally, rebates can induce vertical foreclosure when a producer offers to its retailers in order to discourage them from selling competitors' products, sometimes associated with an exclusivity clause. Competitors may, in an extreme case where there are no alternative distributors or routes to market, then be unable to obtain access to a distribution network to sell their products.

3. Problems with Regulation/Enforcement

3.1 *Avoiding Over-Reach and Ambiguity*

15. Taking into account the distinction between procompetitive and anticompetitive use of fidelity rebates, there is a basic premise that competition agencies should tackle anticompetitive use of fidelity rebates by firms holding very substantial market power, while they should not be concerned with the more widespread, procompetitive use of fidelity rebates by many businesses.

16. If that basic premise is accepted as to when competition agencies should try to intervene in respect of fidelity rebates, the question then becomes how agencies can best do that. There are inherent risks in any attempts by competition agencies to craft rules concerning the use of fidelity rebates, and in determining related enforcement priorities. On the one hand, implementation of overly-restrictive rules or enforcement priorities gives rise to the danger that firms would be prevented from competing on the basis of superior efficiency. This could have the effect of deterring procompetitive pricing practices and thereby harm consumers. On the other hand, if agencies implement rules that create or nurture an environment of ambiguity, this can be as damaging to competition as the adoption of overly-restrictive regulation. In order to have a system of regulation that can be fair, effective and practicable, businesses need to have well-defined, predictable legal rules on rebates and pricing, which also effectively address clear competitive abuses.

17. BIAC recognizes that it is difficult to apply theoretical economic tests to market realities in a way that will ensure a procompetitive outcome. We therefore encourage the development of regulatory policies that allow businesses to conduct a reasonable *ex ante* self-assessment of compliance. This "reasonable opportunity to self-assess" is consistent with a legal framework – present in a number of jurisdictions – in which intent is a required element of an offence of monopolisation or abuse of dominance. Indeed, distinguishing between companies which flaunt the competition laws and those which compete vigorously on the merits is a key function of a competition regulatory framework.

18. BIAC therefore supports the use of well-established economic theories that are capable of being translated into administrable, well-defined rules. BIAC agrees that fidelity rebates which involve an element of above-cost pricing may also have anticompetitive effects and supports the idea

that firms with substantial market power should not be able to use fidelity rebate schemes as a “cover” for setting prices at predatory levels while avoiding regulatory examination.¹ However, while economic theories that above-cost pricing can harm competition can be used to predict that anticompetitive outcomes may occur, these same theories are poor at showing when such anticompetitive outcomes are actually likely to result. Using these theories as a basis for legal standards may make it difficult for businesses to predict when a fidelity rebate scheme is subject to challenge (particularly when such enforcement is done on an *ex post* basis). Competition agencies may also face difficulties in effectively administering laws based on these theories.

3.2 *Recent Practice in Europe*

19. One of the key challenges perceived by BIAC is the limitations of legal institutions in translating complex economic theories into rules of law. Developments over the past few years have demonstrated that identifying and then appropriately codifying the “correct” economic theory in order to regulate anticompetitive use of fidelity rebates can be challenging.

20. The adoption by the European Commission (“Commission”) in 2009 of its guidelines on enforcement of Article 102 TFEU (“Guidelines”),² appeared to herald a shift in EU enforcement practices towards a more effects-based approach to enforcement of the law on abuse of dominance. Consumer welfare was put forward as a relevant standard to help distinguish harmful practices from harmless, with the balancing of anticompetitive effects with any countervailing efficiencies given a prominent role. For fidelity rebates specifically, the Commission outlined an analytical framework under which a rebate would only be deemed to be abusive if it could foreclose equally-efficient competitors.³ Under the Commission’s Guidelines, measuring the potential of a rebate scheme to foreclose an equally-efficient competitor requires determining the effective price that such a competitor would have to offer in order to have a customer switch away a part of its demand from the dominant firm (a test known as the as-efficient-competitor (“AEC”) test).⁴

21. Although the Commission’s approach is thus one of assessing whether the effective price is below long-run average incremental costs and/or the average avoidable costs, the Commission states explicitly in its Guidelines that its theory of economic harm does not rely on predatory pricing.⁵ In other words, the theory is that a rebate scheme might have a foreclosure effect on an equally-efficient competitor even though the rebate scheme does not involve an element of sacrifice for the dominant firm.⁶

22. In important Court of Justice judgments – namely *Tomra*⁷ and *Post Danmark II*,⁸ EU jurisprudence has been developed further⁹. In both cases, the need for application of an AEC test was

¹ See, Background Note by the Secretariat, ¶ 74.

² Guidance on the Commission’s enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, 2009 O.J. (C 45) 7 [hereinafter Guidelines].

³ Guidelines, ¶¶41-45.

⁴ *Ibid.*

⁵ Guidelines, ¶ 37, footnote 3.

⁶ See, Damien Neven, *A Structured Assessment of Rebates Contingent on Exclusivity*, 1 Competition Law & Policy Debate 86, 94 (discussing of a sacrifice test *versus* a matching test).

⁷ Case C-549/10 P, *Tomra Systems ASA and others v Commission* [2012] ECLI:EU:C:2012:22.

⁸ Case C-23/14, *Post Danmark A/S v Konkurrenceradet* [2015] ECLI:EU:C:2015:651.

⁹ And may be developed further by the Court of Justice in the appeal in the Intel case. Case T-286/09 *Intel Corp v European Commission*, judgment of 12 June 2014.

rejected. However, as has been argued by commentators in the wake of these judgments,¹⁰ none of these cases result in a finding that the Commission should not continue to apply the principles outlined in its 2009 Guidelines, including the AEC test in respect of rebate schemes. While the *Intel* and *Tomra* cases dealt with a set of circumstances to which the Commission's 2009 Guidelines did not apply, the Guidelines did apply in *Post Danmark II* and factored in the Court of Justice's reasoning as such. However, the Court of Justice explicitly confirmed that its conclusion in that case "ought not to have the effect of excluding, on principle, recourse to the as-efficient-competitor test in cases involving a rebate scheme for the purposes of examining its compatibility with Article 82 EC."¹¹

3.3 *Potential Chilling Effect*

23. Setting aside for a moment the idea that the use of an AEC test continues to have validity in the EU, even if the use of a price-cost test such as the AEC test were not to be considered the most suitable proxy for assessing the anticompetitive nature of a fidelity rebate scheme, BIAC is concerned that there is currently no clear alternative basis on which competition agencies can base their rules and prioritize enforcement of those rules in respect of fidelity rebates. Any temptation that competition agencies might have to try to adopt more restrictive rules (e.g. to attempt to deal with the "softening" of competition between rivals rather than the exclusion of rivals) should be outweighed by the potential chilling effects that such rules might have.

24. Significant chilling effects can result from overly-inclusive rules regarding fidelity rebates. U.S. Supreme Court Justice Stephen Breyer explained the problem as follows: "[T]he consequence of a mistake here is not simply to force a firm to forego legitimate business activity it wishes to pursue; rather, it is to penalize a pro-competitive price cut, perhaps the most desirable activity (from an antitrust perspective) that can take place in a concentrated industry where prices typically exceed costs."¹² Although of course fidelity rebates do not necessarily involve pure price cuts, BIAC believes that there is still great potential for price competition to be chilled if the ability (or tendency) of firms to introduce price differences through fidelity rebates were to be limited by the adoption of overly-restrictive rules. In practice, the formidable penalties for allegedly abusive rebates that have been handed down in the past highlight the risks of chilling potentially procompetitive discounting behaviour, precisely as outlined by Justice Breyer; in the absence of unambiguous, bright-line rules, businesses are unlikely to be able to carry out the sort of lengthy, nuanced analysis required, while under the threat of the imposition of massive fines.

4. **What Should Agencies Do?**

25. In determining the best way forward for enforcement by competition agencies, several factors need to be balanced against each other: i) the need for agencies to tackle clear abuses by firms with substantial market power, ii) the need to avoid over-regulation leading to a chilling effect on price competition, and iii) the need to avoid ambiguity in order to facilitate effective enforcement by agencies and compliance by businesses. Ultimately, the difficulty that legal institutions have in translating complex economic theories into rules of law means that any rules need to be clear and unambiguous.

26. It is difficult to demonstrate decisively which approach (one that errs on the side of over-regulation or one that takes a more *laissez-faire* approach) brings with it more risk. The consequence of principled under-enforcement may be limited to those markets in which (presumably few) firms with substantial market power are using anticompetitive rebate schemes to entrench or even enhance their dominance, with detrimental effects on competition. The consequence of unprincipled over-

¹⁰ See in particular Nicolas Petit, *Rebates and Article 102 TFEU: The European Commission's Duty to Apply the Guidance Paper*, available at <http://www.lcii.eu>.

¹¹ *Post Danmark II*, ¶ 58.

¹² *Barry Wright Corp. v ITT Grinnell Corp.*, 724 F.2d 227, 235 (1st Cir. 1983).

enforcement, however, is to put at risk the procompetitive pricing offered by the many firms that are not using their rebate practices in an anticompetitive manner.

27. BIAC believes that, in the context of a regulatory environment where there are competing economic theories of harm and case law that could cast some doubts over the application of those economic theories, at the very least agencies' enforcement practices should not be based on any theoretical model where the cost of error is a direct reduction in consumer welfare.

4.1 *Price-Cost and as-Efficient-Competitor Tests*

28. In previous discussions related to rebates (and certain other types of discount practices), BIAC has advocated the use of a price-cost test as a demonstrably predictable, administrable, and reasonably effective way of deterring anticompetitive behaviour. Predictability of such a test relies on the fact that individual firms can assess the relationship of their prices to their costs.¹³ Ease of administration for agencies depends on the proven ability of legal institutions, within the context of predatory pricing actions, to deal with the economic assessment of price-cost standards. And effectiveness rests on the ability of the rules to address the one form of pricing conduct that is widely understood, based on accepted economic theory, to create harm.

29. BIAC has recognized that a price-cost test can have shortcomings and may allow certain conduct that can harm competition to go without remedy, but BIAC does not believe that any of the alternative economic models are perfect. Indeed, alternative economic models that show that above-cost discounting can be anticompetitive face serious challenges in terms of ease of administration. Use of a price-cost test also benefits from avoiding the lost consumer welfare associated with over-enforcement, which may well outweigh the costs of under-enforcement for the marginal number of cases that will go without remedy under this approach. In the absence of direct evidence of harm to consumers from fidelity rebates, it is possible that application of a price-cost test is the most appropriate approach to take.

30. An important feature of an above-cost price test is that competitors who demonstrate superior efficiency are protected. Exclusion through superior efficiency is, of course, a normal form of competition; it is the way through which firms with a lower cost structure or superior products succeed in the marketplace. A price-cost test thus effectively filters out of the antitrust enforcement mechanism most instances in which the exclusion reflects the superior capabilities of the allegedly excluding firm.¹⁴

31. The utility of a test for pricing conduct that focuses on the exclusion of an equally efficient competitor has been recognized both in the U.S.¹⁵ and the EU.¹⁶ In both jurisdictions, the result of

¹³ The calculation of costs can be a complex matter, but such calculations are within the capability of selling parties, and place a reasonable burden on selling parties to determine their costs in relation to prices.

¹⁴ There are models that show exclusion of equally efficient competitors without below-cost pricing. However, these models do not show that consumers are harmed. For example, under the Nalebuff model, consumer welfare increases. And under the Greenlee, Reitman, and Sibley model, the bundled price that causes the exclusion "can either raise or lower consumer welfare." Patrick Greenlee, David Reitman & David S. Sibley, *An Antitrust Analysis of Bundled Loyalty Discounts* at 5 (U.S. Department of Justice, Antitrust Division, Economic Analysis Group Discussion Paper EAG 04-13, 2004).

¹⁵ See, e.g., *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883, 906-09 (9th Cir. 2008); *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039, 1061 (8th Cir. 2000); *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 232; Antitrust Modernization Commission, REPORT AND RECOMMENDATIONS 100 (2007)10; Philip E. Areeda & Herbert Hovenkamp, ANTITRUST LAW ¶ 749a at 241, ¶ 1807 at 419 (Supp. 2007).

¹⁶ Guidelines, *supra* note 2.

focusing on exclusion of an equally-efficient competitor has been a price-cost test. As one U.S. court noted with respect to an above-cost loyalty discount program, “a firm’s ability to offer above cost discounts is attributable to ‘the lower cost structure of the alleged predator, and so represents competition on the merits. . . .’”¹⁷ The European Commission’s Guidelines, as noted above, has also adopted an AEC test.¹⁸ The Commission has applied this standard to fidelity rebates and, as discussed further above, is likely to continue to do so, following the *Intel*, *Tomra* and *Post Danmark II* judgments, none of which have struck down the basis on which the Commission applies an AEC test in the assessment of fidelity rebates.

32. A risk to which the use of price-costs test may give rise is that an inappropriate proxy may be used as a measure of cost. In the U.S., a broad consensus exists that the proper cost measure should reflect a proxy for incremental cost, with average variable cost being the most commonly-endorsed proxy for this measure.¹⁹ The European Commission’s 2009 Guidelines adopted an approach of using both the long run average incremental cost (“LRAIC”) and average avoidable cost (“AAC”) as proxies (if the effective price is below LRAIC but above AAC, the Commission will also take into account other factors in order to determine whether entry or expansion may be affected).

33. A test focusing on incremental or avoidable costs generally has at least two advantages. First, from a policy perspective, it avoids labelling as anticompetitive price cutting that increases short run profits and does not depend on exclusion to be profitable. Prices above incremental cost benefit consumers by allowing them to buy at lower prices. Second, from an implementation standpoint, an incremental cost measure does not require a judgmental allocation of joint costs that are incurred in the development or manufacture of multiple products. This leads to greater predictability, which in turn reduces the potential for antitrust rules to inhibit legitimate price cutting.

34. The use of an incremental cost measure is necessary for another reason. Because sales under a discount or rebate scheme often are not temporal, the methodology for assessing the revenues and costs also cannot be temporal. In evaluating any conduct, one should consider both the revenues and costs that are associated with (i.e., incremental to) that conduct. This is necessary to determine whether the conduct can exclude an equally efficient competitor or whether it is profitable without depending on the exclusion of rivals. Thus, the same sales increment, in terms of volume and time, should be used to measure both the revenues and costs. If the increment is a relatively small one covering a very short span of time, such as a single sale or small group of sales, there are unlikely to be significant investment decisions associated with it and the appropriate measure of incremental cost is likely to be average variable cost. In contrast, if the sales increment is significant enough in terms of volume or duration to capture major investment decisions, such as a multi-year sales contract that is significant in proportion to the firms’ total sales, a longer-run increment of cost – such as long run average incremental cost – may be required. Using a different measure would not properly evaluate the incremental cost because investments in manufacturing or distribution may be incremental to those sales. Thus, a true comparison of price and cost requires that the same increment be used to measure both revenues and costs.

35. Moreover, to justify intervention, the rebate scheme should risk foreclosure of a significant share of the market over a substantial period of time. In small scale, even exclusionary discounting practices may harm only a competitor, not competition. In the U.S. Courts, it has been recognized that “[P]romotional discounts raise no antitrust problems . . . though often they are below incremental cost

¹⁷ *Concord Boat*, 207 F.3d at 1061.

¹⁸ See Guidelines, *supra* note 2.

¹⁹ See, e.g., *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883, 910 & n.20 (9th Cir. 2008); *United States v. AMR Corp.*, 335 F.3d 1109, 1116 (10th Cir. 2003); *Advo, Inc. v. Philadelphia Newspapers, Inc.*, 51 F.3d 1191, 1198 (3d Cir. 1995); *Stearns Airport Equip. Co. v. FMC Corp.*, 170 F.3d 518, 532 (5th Cir. 1999); *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 235-36 (1st Cir. 1983); *Northeastern Tel. Co. v. AT&T*, 651 F.2d 76, 87-88 (2d Cir. 1981).

in a superficial sense. Superficial because they may be above that cost when the promotional value of the discounts is added to the discounted price, as it should be to construct the full price with which to compare incremental cost.²⁰ But where the promotion is of short duration or impacts few customers, the potential for harm to competition is muted.

5. Conclusion

36. BIAC believes that competition agencies need to endeavour to formulate and enforce the clearest, simplest rules on fidelity rebates that they can. In doing so, agencies will equip businesses with the means to be able to assess compliance and to avoid abuses in the limited number of circumstances where firms with substantial market power could run fidelity rebate schemes with anticompetitive outcomes.

37. The immediate priority, in BIAC's view, is for agency efforts to focus on achieving some degree of convergence in terms of codifying the various competing economic theories of harm and enforcement practices into simple, unambiguous rules that enable businesses to self-assess their own rebate and discounting practices. Facilitating that sort of self-assessment environment will in itself assist agencies greatly in being able to administer rules on fidelity rebates in an efficient way. In the absence of a reasoned consensus on which theory of harm and model of enforcement to adopt, BIAC believes that the only safe way to proceed is to be cautious in the approach to adopting any new rules which might bring with them the risk of over-enforcement, thereby ultimately stifling price competition.

²⁰ Am. Academic Suppliers v. Beckley-Cardy, Inc., 922 F.2d 1317, 1322 (7th Cir. 1991).