Competition

April 2017

COMPETITION BULLETIN





Welcome to the April edition of our Competition Bulletin

The Competition Bulletin covers developments in competition law, including merger control.

In this issue we discuss three topics:

- Competition litigation: the recent MasterCard interchange fee judgments and their relevance for competition damages claims.
- Merger control: analysing the elements of the failing firm defence in merger control proceedings.
- EU Merger Regulation: examining potential changes to the EU's merger control regime.

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A tale of two judgments: the MasterCard interchange fee decisions and their relevance for competition damages claims

Summary

The Consumer Rights Act 2015 has introduced changes to the UK's competition damages regime, which has made the UK an attractive jurisdiction in which to bring actions for breaches of competition law.

Such competition damages actions are relatively new in the UK, and can be heard by either the High Court or the specialist Competition Appeals Tribunal (CAT). As the High Court is not bound by the decisions of the CAT in competition damages cases there is a risk that inconsistent judgments may have a chilling effect on competition damages actions being brought in the UK.

The differences between the judgment of the CAT in *Sainsbury's v MasterCard*[1] (Sainsbury's Judgment) and the judgment of the High Court in *Arcadia v MasterCard*[2] (Arcadia Judgment) are illustrative: the two judgments give a very different legal interpretation of similar circumstances.

However, the MasterCard proceedings, and related VISA proceedings, are atypically complex, and the fact that inconsistent judgments have been handed down should not dissuade potential claimants from considering bringing a claim in the UK for any damages they may have sustained as a result of an infringement of competition law, which should be considered as an investment opportunity.

The facts

Both MasterCard and VISA operate four-party payment systems for transactions by debit and credit cards. Such payment systems are 'four-party' as they involve:

1. A cardholder.
2. A merchant.
3. The cardholder's bank (Issuing Bank).
4. The merchant's bank (Acquiring Bank).

When a cardholder pays a merchant for goods, the cardholder's issuing bank deducts an interchange fee from the money it pays to the merchant's acquiring bank for processing the transaction.

The MasterCard and VISA scheme rules applying to the UK have set a default interchange fee that will apply unless an issuing bank and an acquiring bank have negotiated a separate interchange fee between themselves. This default interchange fee is known as a Multilateral Interchange Fee (MIF)[3]. A higher MIF is generally set for credit transactions than the one which is set for debit transactions.

These MIFs may be passed-on by the acquiring banks to merchants as part of the merchant service charge. In the Arcadia Judgment it was concluded by the court that the MasterCard MIFs constituted a floor, below which the merchant service charge could not fall.

In both the Sainsbury's and Arcadia cases the claimants contended that MasterCard's MIFs breached Article 101 of the Treaty on the Functioning of the European Union/Chapter I of the UK's Competition Act 1998. Both provisions prohibit agreements which have an anti-competitive object or effect unless they meet all of the following criteria (Article 101(3) criteria), which are that the relevant agreement:

- Contributes to improving the production or distribution of goods or to promoting technical or economic progress.
- Allows consumers a fair share of the resulting benefit.
- Does not impose restrictions which are not indispensable to attaining the above objectives.
- Does not afford the parties to the agreement the possibility of eliminating competition in respect of a substantial part of the products in question.

In both judgments it was concluded that there was a relevant agreement between MasterCard and its licensees, (the Issuing Banks and Acquiring Banks participating in the MasterCard scheme).

In both judgments it was accepted that the MIFs did not have an anti-competitive object. Agreements that are determined to have an anti-competitive object are almost always prohibited[4], there is no need to prove that they actually have an effect on competition on the relevant market. Agreements which fix prices or allocate customers or territories between competitors are generally held to have an anti-competitive object. The MIFs were not a price-fixing agreement, as they operated as a default provision in the absence of individual issuing banks and acquiring banks negotiating an interchange fee between themselves.

1 *Sainsbury's Supermarkets Ltd v MasterCard Incorporated and Others* [2016] CAT 11.

2 *Asda Stores Limited and Others v MasterCard Inc and others* [2017] EWH 93.

3 Both MasterCard and VISA have set separate MIFs for cross-border transactions, and MIFs applicable in other jurisdictions. Whilst such MIFs are of relevance to the actions that have been brought against MasterCard and VISA this article only refers to MIFs set in the UK.

4 Agreements which have an anti-competitive object may in theory be exemptible under the Article 101(3) Criteria.



The counterfactual

To analyse whether a particular agreement has the effect of restricting competition it must be assessed against circumstances that might have been likely to exist had the agreement not been in place. This is known as a counterfactual analysis. If the agreement creates conditions that are more restrictive of competition than the conditions that would exist in the counterfactual, then the agreement will have an anti-competitive effect.

Deciding upon an appropriate counterfactual will not always be easy, and the two judgments came to different conclusions. In the Sainsbury's Judgment it was held that the appropriate counterfactual would be that no MIF would be set, and that issuing and acquiring banks would bilaterally agree interchange fees. The CAT concluded that if interchange fees were bilaterally negotiated the interchange fees would be, on average, 0.5% of the value of credit card transactions and 0.27% of the value of debit card transactions. The MasterCard MIFs had been set above these levels, and therefore Sainsbury's was entitled to damages.

In the Arcadia Judgment this approach was rejected by the court as unfeasible for a number of reasons, including its opinion that an impractically large number of bilateral agreements would need to be negotiated. The court instead stated that the only potentially realistic counterfactuals were:

- A scenario with no MIF and a prohibition on issuing banks imposing an interchange fee following a transaction.
- A lower MIF as the maximum putatively lawful MIF.

In relation to the first counterfactual, the court stated that the MasterCard MIFs would have had the effect of restricting competition on the acquiring market

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(the market between acquiring banks and merchants) had it not been for the fact that under this counterfactual the MasterCard scheme would have collapsed, as issuing banks would have switched to issuing VISA cards.

In relation to the second counterfactual, the court stated that, although it considered that the MIFs as set were in fact lawful under the Article 101(3) Criteria, any MasterCard MIF that was set at a level that was more than 0.2% per transaction lower than the VISA MIF would also lead to collapse of the MasterCard scheme, as issuing banks would again have switched to issuing VISA cards.

In relation to both of these counterfactuals, the lawfulness of VISA's MIFs was assumed by the court, and therefore it was assumed for the purpose of the counterfactual that VISA would continue to maintain their MIFs at current levels. In relation to both counterfactuals the key issue was whether a MasterCard scheme with no or lower MIFs would be able to compete with a VISA scheme which lawfully maintained their MIFs at present levels.

Outcome

This will become problematic, as there are currently a large number of claims against VISA pending (at the time of writing no judgment has been issued in any claim brought against VISA). If it is determined that in these claims that VISA's MIFs were set at an unlawful level then the Arcadia Judgment's conclusion on counterfactuals will be open to challenge - if VISA could only lawfully not set a MIF or set a lower MIF, then the MasterCard scheme would not collapse if it also did not set a MIF or set a lower MIF.

The Sainsbury's Judgment and the Arcadia Judgment also reached different conclusions on whether the Article 101(3) Criteria applied. In the Sainsbury's Judgment it was determined that the Article 101(3)

Criteria did not apply to the MIFs set by MasterCard during the relevant period, and therefore the agreement, which had the effect of restricting competition, could not be exempted by the application of these criteria. In particular, the CAT found that the MIF inhibited economic progress, rather than promoted economic progress, as it frustrated bilaterally negotiated interchange fees and as a result created upward pressure on merchant service charges.

In the Arcadia Judgment it was determined that the MIFs were set by MasterCard at levels which would be permitted under the Article 101(3) Criteria. In doing so the court quantified what relevant benefits merchants derived from the MasterCard MIF and determined that MIFs set below this level would be exemptible under the Article 101(3) Criteria. The court determined that MasterCard credit MIFs set at or below 1.11% of transaction value and MasterCard debit MIFs set at or below 0.38% of transaction value would be exemptible. MasterCard's UK MIFs were set below this level for the duration of the claim period.

Permission to appeal was refused in *Sainsbury's v MasterCard*. It would appear likely that the unsuccessful claimants will attempt to appeal *Arcadia v MasterCard*. Upcoming judgments in cases brought against VISA are also likely to impact on the reasoning underpinning the counterfactual part of the judgment in *Arcadia v MasterCard*.

It seems somewhat inevitable that certain issues will have to be determined by the Court of Appeal, and possibly the Supreme Court, in order to ensure some degree of consistency is applied to the competition damages proceedings brought against MasterCard and VISA.

Stand alone and follow-on claims

Whilst the existence of inconsistent judgments would typically dissuade potential claimants from bringing claims it should be stressed that the MasterCard and VISA actions are not typical of competition damages claims.

A claim for damages for a breach of competition law may be brought on a 'stand-alone' or 'follow-on' basis. A follow-on claim may be brought where there is a decision of the Competition and Markets Authority (CMA) or the European Commission that an infringement of competition law has taken place. In a follow-on claim, the courts or the CAT will be bound by this regulatory decision, and therefore will generally only consider whether the infringement caused the claimant loss. On the other hand, in a stand-alone action a claimant must also prove that an infringement has taken place.

As claimants against MasterCard and VISA cannot rely on a relevant regulatory decision establishing that MasterCard and VISA's UK MIFs were unlawful, claims have to be brought on a stand-alone basis. This has required claimants to evidence the existence of an infringement of competition law to a satisfactory standard.

In addition, the fact that claimants have had to prove that the MIFs as set had the effect of restricting competition – as the argument that setting MIFs has the object of restricting competition has not met with success – and the fact that a large number of different claims have been brought by different parties, has resulted in uniquely complex litigation.

Claims brought on a follow-on basis should not provoke the same degree of complexity. Companies which have suffered damage as a result of an infringement of competition law that is the subject of a decision of the CMA or the European Commission should still explore bringing a follow-on claim to recoup the cost of any overcharge they may have incurred.

hfw The failing firm defence: when failure is the opportunity

Summary

Many merger control proceedings involve the acquisition of a firm, or the assets of a firm, that is in financial difficulties, or has decided to exit a particular market. If such an acquisition takes place in a market(s) that already has a small number of competitors, there is a reasonable possibility that the merger could be referred to a detailed Phase II investigation because there is a realistic prospect that the anticipated merger would lead to a substantial lessening of competition in the relevant market(s). There is also a possibility that the merger could be blocked following a Phase II investigation because the anticipated merger would be likely to lead to a substantial lessening of competition on the relevant market(s).

In such situations the merging parties may consider making use of the failing firm defence to gain merger clearance at the earliest possible opportunity. However, satisfying a competition authority that the three elements of the failing firm defence are met is far from straightforward, and a competition authority may be more receptive to its use during Phase II proceedings, where it can review and test the evidence it is presented in greater detail.

The test

The three elements of the failing firm defence are as follows[1]. The merging parties must prove that each of these three elements are met for the failing firm defence to be accepted by the competition authority:

1. Would the 'failing firm' have exited the market if the merger did not take place.

Whilst this will most commonly be considered in cases where a firm is



in financial difficulty, it may also be assessed in cases where a firm has taken a decision to stop operating in the market(s) under consideration. An example is the CMA's decision in *DHL/Carlsberg*[2]. In this case DHL Supply Chain Limited agreed to acquire certain assets from Carlsberg for the purpose of providing porterage contract logistics services[3] to Carlsberg. The CMA came to the conclusion that Carlsberg had made a decision to stop offering such services, without analysing whether it was inevitable that Carlsberg would have had to stop offering such services for financial reasons.

In a situation where it is claimed that the target would have left the market had the merger not taken place due to acute financial difficulties, a Competition Authority will usually not simply limit its review to an analysis of the company's accounts. It would also want to look closely at internal documents prepared before the specific merger was under consideration. It will typically want to see high-level evidence, for example in minutes of Directors' meetings, that the firm had taken alternative strategies to a merger into consideration but had rejected them on reasoned grounds.

For example, in the CMA's recent decision in *East Coast Buses/First East Scotland*[4], which the CMA cleared on the basis of the failing firm defence, the CMA undertook a detailed review of the target's contemporaneous documents, such as board minutes, management accounts and strategic plans, in addition to a review of its financial information. Reviewing such documents allowed the CMA to conclude that the first element was met, as they contained sufficient evidence that First East Scotland had planned to exit its east coast business for some time before selling it to East Coast Buses, and had attempted to exit this business through alternative means (by selling bus depots to a property developer) independently of any consideration of selling it to East Coast Buses.

2. Was there a realistic less anti-competitive purchaser for the 'failing firm'.

This element has two element limbs:

1. Whether there are realistic alternative purchasers.
2. Whether any acquisition by a realistic alternative purchaser would result in a less anti-competitive outcome.

A realistic alternative purchaser does not necessarily need to already be operating in the same market. If a firm operating in a neighbouring market had expressed interest in a purchase and would, with the purchase, have sufficient assets and know-how to operate in the market(s) under consideration then it could be considered to be a credible alternative purchaser.

With regard to the second limb, it may be that the only realistic alternative purchaser(s) already operates in the same market as the merging parties. If this alternative purchaser(s) has a larger market share than the actual purchaser, then it is unlikely that it would be considered a less anti-competitive purchaser.

3. Whether the loss of the firm and its assets would have a less anti-competitive effect on the relevant market(s) than the merger.

If the first two elements are met, a competition authority will want to determine that it would not be less anti-competitive to accept a reduction in the number of competitors on the relevant market(s).

When assessing whether this third element is met, the CMA will usually focus its analysis on what would happen to the exiting firm's sales if the merger were to not take place. If there were evidence that the customers of the exiting firm would mainly switch to purchasing from a firm with a smaller market share than the merging parties, or would switch to purchasing from the remaining firms in roughly equal volumes, then a conclusion that the loss of the firm and its assets would have a less anti-competitive effect on the relevant market(s) than the merger would be more likely.

On the other hand, if it were determined that the exiting firm's customers would mainly switch to buying from the acquiring firm or a firm with a larger market share than the merging parties, then a conclusion that the loss of the firm and its assets would have a less anti-competitive effect on the relevant market(s) than the merger would be less likely.

The European Commission takes a different approach to this third element, and will usually assess what would happen to the assets of the exiting firm in the absence of the merger. If the assets of the failing firm can be usefully re-deployed on the market, then the Commission may determine that the loss of the firm and its assets would have a less anti-competitive effect on the relevant market(s) than the merger.

Conclusion

In general meeting all three elements is difficult, and failing firm defences are often rejected by competition

1 There is a slight variation in the application of the test between the UK's Competition and Markets Authority (CMA) and the European Commission.

2 Anticipated acquisition by DHL Supply Chain Limited of the enterprise constituted by the secondary distribution assets of Carlsberg Supply Company UK Limited, Decision on relevant merger situation and substantial lessening of competition. Case ME/6628/16,. 9 February 2017.

3 Porterage services are delivery-only distribution logistics services to on-trade retail outlets such as pubs and restaurants.

4 Completed acquisition by East Coast Buses Limited of the east coast operations of First Scotland East Limited, Decision on relevant merger situation and substantial lessening of competition. Case ME/6642/16.

authorities. Merging parties may have to produce a significant amount of evidence to support their case. In addition, it is likely that a competition authority will request evidence and comments from third parties, including potential alternative purchasers and customers of the target, and the merging parties will not have control over this. Nonetheless, in situations where there is a risk that the merger could be blocked, or only approved on the basis of the merging parties offering significant commitments, it is worth considering whether a failing firm defence can be made out.

Mending the net: proposed changes to EU merger control

Summary

On 7 October 2016, the European Commission launched a public consultation entitled the "Evaluation of procedural and jurisdictional aspects of EU merger control" as part of its plans to refine the EU merger control framework. Proposed key changes include the introduction of a size-of-transaction test for mergers and a simplification of the merger notification system. Apart from cutting red tape, the changes are likely to affect in particular the technology and pharmaceutical sectors as well as start-ups.

Background

Following a public announcement by European Commissioner for Competition, Margrethe Vestager, in March last year, the Commission is considering filling a significant enforcement gap for high value transactions. In particular, this means that certain important mergers in the technology and pharmaceutical sectors which do not meet the current EU jurisdictional merger thresholds may become subject to merger control proceedings under revised thresholds. Furthermore, there are plans to assess to what extent the procedural aspects of EU merger control can be simplified. We provide below an update on the main proposed changes and how they could affect businesses in the future.

The introduction of a size-of-transaction test

Although there is widespread consensus that the EU merger control regime operates efficiently and generally serves its purpose, there are concerns that it has struggled to keep up with certain business trends, notably in respect of takeovers of companies which own disruptive technology.

The EU merger control framework

In order to prevent distortion of competition in the EU, concentrations with a Union dimension are subject to an ex-ante review and approval by the European Commission. Whether or not a transaction has to be notified to the Commission is determined by applying the turnover test set by the EU Merger Regulation (EUMR)[1]. The test is predominantly aimed at identifying mergers and full-function joint ventures between companies with high turnovers within the EU and reviewing these transactions to ensure that they would not lead to a substantial lessening of competition.

A case for reform – technology sector/ start-ups

In the words of Director-General of DG Competition Johannes Laitenberger, *"not every merger is about a company's turnover today; sometimes, it's about the potential to make money tomorrow."*[2]

What the turnover test does not capture are mergers between businesses which do not meet the EUMR turnover thresholds but are of a high value. A key example is start-ups which develop around an idea, invention, patent or application and are, at very early stages of their existence, acquired by a large corporation for a high price. At present, concentrations that fall below the EUMR turnover thresholds are still open to review by national competition authorities if the relevant national thresholds are exceeded. Under Article 22 EUMR, if a transaction does not meet the EUMR turnover thresholds, but "affects trade between

1 Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings.

2 "Tackling the issues that matter to consumers" (speech delivered on behalf of Commissioner Vestager) at the AmCham EU 33rd Competition Policy Conference in Brussels on 26 October 2016.

Member States and threatens to significantly affect competition", one or more Member States can, on their own initiative or at the Commission's invitation, refer the proposed acquisition to the Commission for merger review. Equally, if a transaction meets the notification thresholds under the national competition laws of at least three Member States, the parties themselves may make a reasoned submission to the Commission requesting it to examine the transaction (Article 4(5) EUMR). Thus in 2014 the US$19 billion Facebook/WhatsApp acquisition was below the turnover thresholds for application of the EUMR, but Facebook itself applied for a referral under Article 4(5) EUMR. As this referral mechanism is not mandatory, there are concerns that Article 4(5) and Article 22 EUMR may not be sufficient to subject high-value transactions to merger review by the Commission.

A case for reform – pharmaceutical sector

Similarly, in the pharmaceutical sector, a merger which escaped review by the Commission was the 2015 acquisition of the oncology firm Pharmacyclics and its treatment for blood cancers, ibrutinib, by pharmaceutical company, AbbVie, for US$21 billion. Equally, the acquisition of US biotech company Dyax with a high-value rare heart disease treatment by London-listed drug maker Shire for US$5.9 billion escaped scrutiny by the Commission. Given the enhanced importance of ensuring effective competition on price in the pharmaceutical sector, it is arguable that it is significant that the Commission was unable to review these transactions.

Potential solution – a 'size-of-transaction ' test

The introduction of a size-of-transaction test had been on the Commission's table for a long time, after fruitless consultations in 2009 and 2013, a size-of-transaction test was considered in the Commission's 2014 White Paper and has now been revived.

While a size-of-transaction test is not the norm, many countries have integrated it into their merger control frameworks - the US for instance operates a three-part test consisting of a size-of-transaction test, as well as a jurisdictional test, which seeks to determine whether at least one party is engaged in an activity that may affect commerce in the US, and a turnover test. Canada also has a size-of-transaction test which sits alongside a turnover test.

In the EU, Germany recently revealed plans to introduce a size-of-transaction test into its national merger control framework. With its ninth proposed legislative amendment to the German Act against Restraint of Competition[3], the Federal Ministry of Economics intends to subject to merger review the acquisition of high value target companies whose sales potential has not yet been realised.

Currently, concentrations have to be notified in Germany if all of the following conditions are met:

- The aggregate global turnover of all undertakings involved was at least €500m in the last financial year.
- One undertaking generated a German turnover of at least €25 million.
- Another undertaking generated a German turnover of at least €5 million in the last financial year.

Under the proposal notification will also be required if all of the following conditions are met:

- The price for the target exceeds €400 million.
- The worldwide turnover of all the undertakings concerned exceeds €500 million.
- One undertaking generated a German turnover of at least €25 million.
- The target is 'active in Germany to a considerable extent'.

The dangers of casting the net too widely

The consultation period closed on 13 January this year and the Commission has yet to publish any draft legislative proposal. While there appears to be a strong case in favour of an introduction of the size-of-transaction test, it is by no means undisputed. The International Bar Association Antitrust Committee for instance has voiced concerns that the size-of-transaction test would raise legal and practical issues of implementation that would likely outweigh any perceived benefits, especially since the exact extent of the enforcement gap has not been quantified.

It is also unclear how the transaction should best be linked to the EU. If the geographical nexus is defined too broadly, foreign-to-foreign mergers with limited impact in the EU could potentially be subjected to merger review by European authorities. The proposed German size-of-transaction test has been criticised for causing uncertainty in this regard as there is

3 Entwurf eines Neunten Gesetzes zur Änderung des Gesetzes gegen Wettbewerbsbeschränkungen: http://dip21.bundestag.de/dip21/btd/18/102/1810207.pdf

no definitive guidance on what the target being 'active in Germany to a considerable extent' means.

This emphasises the need for careful yet business-focused wording: the thresholds will have to be set at the right level, the turnover thresholds lowered but the value of the transaction set highly enough so as to ensure that only those transactions that have the potential to restrict competition are caught and reviewed in more detail. In addition, any size-of-transaction test should be phrased in as precise a way as possible so it should be relatively simple for businesses to establish whether their transaction should be reviewed by the Commission with certainty.

Simplification of the merger notification framework

Whilst the size-of-transaction test may introduce further regulation into the merger control framework, the Commission also consulted on a further possible simplification of the merger notification framework. After successfully adopting the first extensive package of simplification measures in December 2013, the Commission is considering whether certain categories of cases which generally do not raise any competition concerns could be freed from the EU merger review procedure. Under the current simplified procedure, companies are required to submit less information to the Commission than required under a full merger procedure. The Commission introduced a range of transactions which will usually qualify for the simplified procedure. Examples include:

- Where the individual merging entities operate in different product and different geographical markets and no merging entity operates in a market that is upstream or downstream from another merging entity.
- Where the parties' overlapping activities are below an aggregate horizontal market share of 20% and below an aggregate vertical market share of 30%.
- Where a party acquires sole control of another party over which it already has joint control.

The Commission is now exploring possibilities to simplify further the simplified procedure, including potentially exempting some transactions that currently qualify for the simplified procedure from the EU merger control net completely. While this could alleviate the administrative burden on some businesses and enable the Commission's resources to be channelled to other areas where they are needed more, we expect the Commission to be very careful and extensively consider the impact on consumers before making a decision to loosen the framework.

Conclusion

As technology develops so do purchasing strategies and so, therefore, must the merger control framework. It is evident that there are gaps in the EU's merger control net. Market power is no longer exclusively defined by quantitative business strength – turnover – but also by the perceived business strength – value. To preserve a fair and open market, high-profile high-value acquisitions must not be treated any differently from equivalent transactions which have to be notified under the current rules, and the Commission is correct to consider adapting its merger control framework accordingly. Technology companies and pharmaceutical companies in particular should keep abreast of any upcoming reforms.

Should the reforms go ahead, it will be for the EU Institutions to ensure that the line between refining European merger control on the one side and imposing additional administrative burdens on businesses on the other is not crossed. Whilst it is inevitable that the net will have to be mended from time-to-time, it should not catch the wrong fish.