

Russian Dominance Rules

An overview of the rules applicable to "market dominating companies" when dealing with distributors

Introduction

It has been widely reported in the Russian press that at the end of July 2011 Russia's Federal Antimonopoly Service ("**FAS**") and the Russian subsidiary of Novo Nordisk ("**Novo Nordisk**") settled their legal dispute over Novo Nordisk allegedly having abused its dominant position on the wholesale market for insulin by refusing to supply and discriminating against certain distributors. FAS had found Novo Nordisk to have steadily reduced the number of distributors to which it supplied insulin products. In 2006 it had 40 distributors, whereas by 2007 the number had fallen to 20, and Novo Nordisk later refused to continue supplies to all but five regional distributors.

Under the circumstances it was to be expected that FAS would see signs of unjustified refusal to supply by a market-dominating manufacturer of pharmaceuticals. In their settlement Novo Nordisk admitted to having abused its dominant position, while in exchange FAS decreased the fine imposed on Novo Nordisk from RUB 86 million (approx. EUR 2.1 million) to RUB 53 million (approx. EUR 1.3 million).

It has also been widely reported in the press that one of the key questions in the dispute was whether or not a dominant supplier may refuse to supply a distributor on the grounds that the distributor engages in corrupt practices. FAS initially rejected this as merely an attempt to justify refusal to supply, which then sparked a debate among international manufacturers about the conflicts between Russian competition rules and foreign anti-corruption requirements such as those established by the U.S. FCPA and the UK Bribery Act. FAS has now clarified that there exists no contradiction and that corrupt practices may be a valid ground for a supplier to refrain from dealing with a distributor that engages in such practices.

Press reports have not gone much beyond this general statement, which, while clearly an important aspect of the Novo Nordisk case, was not the only issue of note. A number of other aspects also deserve consideration in more detail. Following the settlement, various senior officers of FAS set out its position in some detail, which is worth examining. Finally, various related questions that were not directly dealt with in the Novo Nordisk case should nonetheless be pointed out in the context of FAS's approach to refusal to supply cases.

This note contains a selective summary of certain issues that we consider to be of significance for suppliers.

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Only dominant players need to care

- As a general point, it is crucial to remember that the entire debate about unjustified refusal to supply and discrimination against certain distributors only arises where the supplier holds a dominant position in the relevant Russian market. As a rule, dominance only exists where the supplier holds a market share of at least 35 per cent. As a rule of thumb, below this threshold a supplier is generally free to supply and refuse distributors in its sole discretion, including to treat some distributors differently than others.
- Suppliers whose market share is less than 35 per cent only need to bear in mind the following:
 - One should be cautious when determining one's own market share. In many sectors there exists little official guidance from FAS, and as a rule FAS tends to define markets quite narrowly, which may result in unexpectedly significant market shares.
 - Where market data is available from independent analysts, such data should be treated with caution, given that assessments by various analysts often differ significantly. For example, the market share data published by ACNielsen and Euromonitor for consumer merchandise sometimes vary by as much as 20%.
 - In certain sectors such as retail, and in markets that show certain specific characteristics such as so-called oligopoly markets, where very few competitors hold stable market shares over a long period, a company may be deemed to enjoy a dominant position even below the normal threshold of 35 per cent.

Refusals require a case-by-case assessment

- FAS accepts that suppliers are entitled, and may even be obliged, to verify whether or not their distributors engage in corrupt practices. Where they do, the supplier is generally entitled to refuse to supply. FAS also accepts that refusal is not only justified where a distributor itself has engaged in corrupt practices, but also where its founders and controlling shareholders have engaged in corruption. However, this will depend on the circumstances in each particular case.
- FAS does not require that a distributor's corrupt practices must be confirmed by any court decision.

Instead, it is sufficient that official investigations have been opened into fraudulent business practices of the relevant distributor. Mere suspicion or rumour of corrupt practices is however insufficient to justify a refusal to supply.

- Where there is no proof of actual corrupt practices, FAS requires suppliers to contact the public prosecutor's office or other supervisory authority and enquire whether investigations are being conducted into the distributor's activities. Suppliers are also expected to inform the relevant state authorities of any fraudulent practices of which they become aware. However, it is open to question whether or not manufacturers will readily comply, as they will hardly be interested in being drawn into investigations, particularly into possible corrupt practices in the relationships between a distributor and third parties. The supplier's interest will typically be not to expose itself to such risks, so one would assume that most suppliers will abstain from contacting the authorities. At least FAS acknowledges that notifying the state authorities will be sufficient to justify a preliminary refusal to supply. In other words, one does not have to wait for a response from the state authorities in order to refuse supplies.
- Where a distributor has been officially found to have engaged in corrupt practices, that finding will normally be sufficient to justify refusals by suppliers for a longer period of time. In other words, FAS accepts that illegal activities in recent years can be a sufficient reason for a manufacturer to refuse supplies. However, the situation is different if the wrongdoing dates back some time and cannot be assumed to have any significant link to a distributor's present activities.
- FAS has confirmed that refusal to supply is not only justified when a distributor's illegal activities relate to corrupt practices. Significant violations of other legal requirements may equally provide grounds for justified refusal to supply. This may be the case, for example, where a distributor commits a material violation of the rules on public tenders, sells products after their expiry date, breaches the rules on product storage, etc.

Suppliers can prepare themselves

- Market-dominating suppliers are advised to observe the general rules that FAS regularly emphasizes, namely transparency, non-discrimination and no abuse of the right to refuse

supplies. More specifically, suppliers should therefore:

- Draft a policy for the selection of distributors. Since the Novo Nordisk settlement, FAS has repeatedly stated that it has studied Novo Nordisk's newly introduced selection policy in great detail and that it may serve as an example for other companies. One may question whether it is necessary for each supplier to put in place a 30-page policy as in the case of Novo Nordisk. But in any event there should be a written policy that is understandable and contains detailed requirements for the selection of and grounds for refusing a distributor.
- Policies must be easy to access for interested distributors. FAS has repeatedly urged dominant players to publish policies for the selection of distributors on their official websites. Except where there exist exceptional confidentiality reasons, suppliers should feel encouraged to publish their policies before being asked by FAS.
- Based on Novo Nordisk's selection policy, it appears advisable for suppliers to include in their policy:
 - definitions of important corruption-related concepts, such as a bribe, facilitation payment, conflict of interests, etc.;
 - details on the procedural framework for accepting/refusing a distributor, such as the assessment committee and the relevant procedural steps; and
 - the time frame for the process.
- As a rule of thumb, the risk of FAS raising any concerns decreases with the number of distributors that a supplier has. FAS has indicated on various occasions that it will unlikely object to a refusal to contract where a supplier has a large number of distributors, but will more likely do so if the supplier limits the number of distributors to a very small group. This approach raises questions, given that unjustified discrimination against one distributor may exist irrespective of the number of distributors supplied. However, it does confirm FAS's general view that a supplier should aim to increase rather than limit the number of its distributors.
- FAS does not accept criteria in policies for the selection of new distributors which introduce additional requirements beyond those established by Russian laws or which re-verify issues that have already been considered by the supervisory authorities. In other words, where the activity of a counterparty is subject to licensing, the supplier must normally rely on the review carried out by the supervisory authority when granting a licence to the distributor. Depending on the sector, such criteria may involve checks of the distributor's premises or equipment and of the qualifications of the distributor's personnel.
- A supplier is generally entitled to hold its distributors to its own standards of business ethics, including, for example, requiring potential distributors to agree in writing to comply with the supplier's business ethics guidelines and to attend the relevant training.
- It is normally advisable to keep record of the internal steps taken in refusing a distributor, including supporting documents such as reports about decisions of courts or supervisory authorities, press reports about investigations, etc.
- A supplier must apply its selection policies equally to all distributors. The acceptance of a distributor that failed to meet the policy requirements may be considered discrimination. In other words, the refusal to supply a distributor on grounds of certain business practices might not be accepted by FAS if the distributor can cite other distributors that engage in similar practices but are nonetheless being supplied.
- Reporting conditions, such as the obligation to regularly provide information on customers and areas of distribution as well as sales forecasts, must not be used for the purpose of selecting distributors. A supplier may, however, obtain sales reports on the basis of separate services agreements with its distributors.
- It is unclear whether or not FAS would accept a 'partial refusal to supply'. For example, in the pharmaceutical sector a manufacturer may consider refusing supplies to a distributor for further participation in public tenders, while continuing to supply for retail purposes. Some international manufacturers follow this approach on the basis that the risk of corrupt practices in connection with tenders is significantly high, while there is little compliance risk associated with retail activities. On the balance, a decision must be made taking into account all circumstances in the particular case.

Different terms are not necessarily tantamount to discrimination

- FAS appears to accept that certain terms of supply are generally justified and are not necessarily tantamount to discrimination against particular distributors. In relation to the Novo Nordisk policy, FAS did not object to:
 - setting a minimum amount of supply, thereby excluding distributors below that minimum threshold level;
 - providing for different payment mechanics depending on reasonable criteria. The policy may, for example, distinguish various "levels" of distributors by requiring full prepayment from newly appointed distributors and allowing payment periods of up to 120 days for reliable distributors linked to volume thresholds or to the amount of years that the relationship has existed.

Bonuses must be handled with care

- In the Novo Nordisk case the issue of bonuses offered by Novo Nordisk was not specifically raised. However, the Novo Nordisk policy sets out the bonus structure used by Novo Nordisk, and FAS has emphasized that it has read this document in great detail and recommends using it as a point of reference. It is therefore worth pointing out the following:
 - As a general rule, the Russian competition rules recognize volume-related purchase bonuses. As for any other bonuses, there exists very little official guidance from FAS, so there remains considerable legal uncertainty as to if and when other types of bonuses would be justified.
 - Novo Nordisk's policy only sets out a fairly common bonus structure and does not include any unusual aspects. However, in the absence of any guidance it is worth noting that FAS did not object to the following bonuses and their sizes in the pharmaceutical sector:

- a volume bonus subject to the distributor crossing a certain purchase threshold in the range of 5 - 31%, depending on the particular pharmaceutical product;
 - a bonus of 2% for prepayment;
 - a bonus of 2% for compliance with certain contractual terms, such as timely reports and compliance with the supplier's standards of business ethics;
 - a bonus of 3% for keeping available a certain minimum stock;
 - a bonus of 2% for meeting the technical requirements and minimum qualifications specified by the supplier;
- It is unclear whether Novo Nordisk intended to include other bonus payments but ultimately did not due to objections from FAS. Unfortunately, FAS has not commented on the bonus arrangements in any of its official statements following the court settlement with Novo Nordisk.

Summary and Outlook

In summary, FAS's conclusion that there exists no conflict between Russia's competition framework and foreign anti-corruption regimes was important, but also expected. In this respect, FAS corrected its initial decision which – for whatever reason – only took into account the interests of distributors. FAS is now pursuing a more balanced approach that takes into account the legitimate interests of customers requesting supplies and of dominant manufacturers. Moreover, the settlement has provided greater clarity as to how and when a supplier is entitled to refuse supplies on grounds of illegal business practices on the part of the distributor. It has also provided some rare guidance on bonus arrangements used by dominant suppliers.

Not surprisingly, numerous questions remain unresolved. One therefore hopes that FAS continues the approach taken in the Novo Nordisk case, i.e. to publish its decisions together with the underlying factual circumstances. Numerous FAS decisions in various industries with a variety of circumstances are needed in order to form an established practice that will eliminate the legal uncertainty still faced by dominating companies in many sectors of the Russian economy.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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