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Briefing note 15 June 2012

Hong Kong enacts competition law

On 14 June 2012 Hong Kong's Legislative Council voted to enact Hong Kong's first cross-sector competition law, the Competition Ordinance (CO). The prohibitions in the law are expected to come into effect when the new Competition Commission and Tribunal have been established, which the Administration estimates may take approximately 12 months.

The law contains broadly framed prohibitions against anti-competitive agreements and abuse of market power. It does not introduce a general merger control regime at this stage. However, it does introduce a revised merger regime for telecoms-related mergers to replace the existing regime.

The CO provides the regulatory authorities with extensive powers to investigate suspected breaches with potentially significant penalties and other relief powers.

Key issues

- Regulator's Powers and Penalties
- Need for compliance
- Guidelines and exclusions/exemptions
- The Core Prohibitions
  - Serious anticompetitive conduct
  - Other anticompetitive agreements
  - Abuse of market power

The Competition Ordinance is a new and complex piece of legislation. In this briefing, we look at some of the key provisions of the CO and highlight the key issues for Hong Kong businesses:

Regulator's Powers and Penalties

The Competition Authorities have a range of pre-prosecution tools available to them when investigating anti-competitive behaviour. This includes warning notices, infringement notices, and powers to enter into legally binding commitments or leniency agreements with persons alleged to be in breach.

A business or any person who is found to be in contravention of the CO may face a myriad of penalties. These include:

- A pecuniary penalty of up to10% of annual turnover "obtained in Hong Kong" (based on the gross turnover of the undertaking(s) concerned) for each year of infringement, up to a maximum of three years
- Disqualification for up to 5 years from acting as a director or being directly or indirectly involved in the management of a company.

A broad range of other relief may also be imposed, including orders:

- forcing divestiture of business operations, assets or shares
- appointing a third party to take control of property
- striking down or declaring agreements void in whole or in part

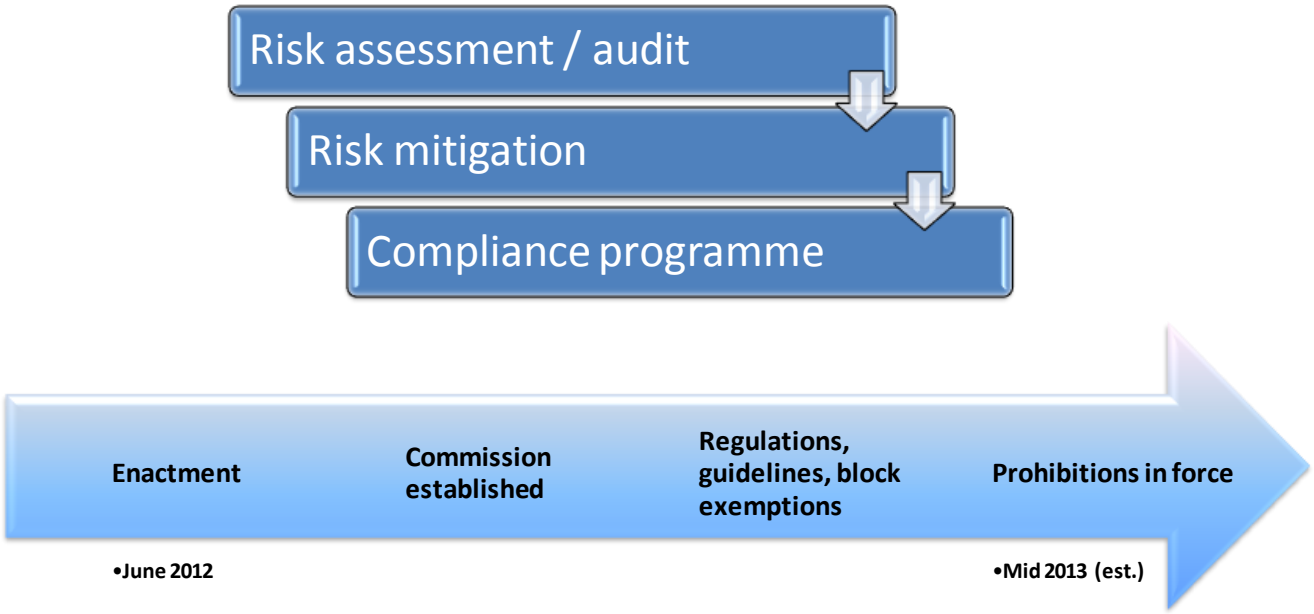
- prohibiting the withholding of goods or services
- striking down conditions attached to contracts of sale or purchase
- prohibiting the exercise of voting rights attached to shares, stock or securities
- compelling access by third parties to a business's goods, services or facilities
- for discouragement of profits to the Government
- for damages to be paid to persons suffering loss as a result of the anticompetitive conduct.

In addition to the above, interim injunctions may be imposed, stopping commercial conduct during investigations and pending prosecution.

The CO also provides for criminal fines (including imprisonment) for obstructing enforcement of the law. This includes destroying documents or concealing them from the Competition Authorities, obstructing searches/dawn raids or providing false or misleading information in an investigation. It is also a criminal offence to terminate the employment of employees or to discriminate against them where they have provided material to the Competition Authorities or agreed to give evidence for them. Businesses should be aware that there are restrictions on the ability to indemnify officers and employees against offences and pecuniary penalties and penalties may be imposed for attempts to do so.

In addition to the specific enforcement powers, the Competition Authorities are mandated to advise the Government on competition matters in and outside Hong Kong and to conduct market studies. There is no clarity yet as to how extensively the market study power will be used.

Need for compliance



The key to meeting the challenges of this new law are:

1. a risk assessment / competition audit;
2. early action to mitigate identified risks and red flag conduct; and
3. implementation of a robust compliance programme.

As the competition law breaks new ground in Hong Kong, the Competition Authorities may seek to look at overseas jurisdictions for best practice in dealing with compliance issues. An effective compliance programme should significantly reduce the chances of breaching the Ordinance and has, in other jurisdictions, gone some way towards mitigating penalties for inadvertent breaches.

Companies should therefore take early steps to understand the impact of the CO on their businesses, their potential exposure and what steps need to be undertaken in order to minimise the risk of prosecution.

Guidelines and exclusions/exemptions

The CO sets out the basic framework of the law. However, it will be supplemented by:

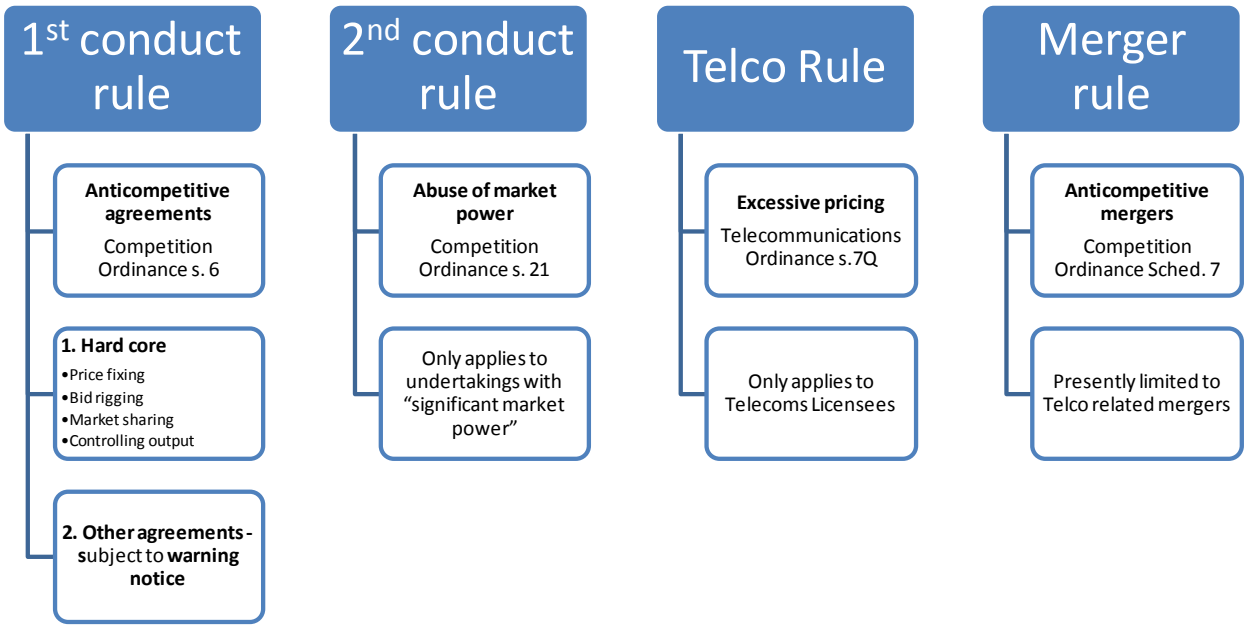
- Guidelines from the Competition Authorities; and
- Block exemptions and other regulations relating to exclusions and exemptions.

The Guidelines and block exemptions are expected to play a crucial role in giving clarity to businesses in the early stages as to what behaviour is and is not prohibited.

There are various exclusions and exemptions. Businesses need to know how these operate, and to assess whether they will benefit from them. There are also avenues for seeking clarification from the Competition Authorities where it is not clear whether conduct is in breach. Businesses will need to consider whether they should be approaching the Competition Authorities under these procedures for clarity.

Early steps should also be taken to try to resolve any red flag issues, which may include negotiations with counterparties to try to remedy agreements that contain terms that risk being in breach of the law.

The Prohibitions



The CO repeals the existing sectoral competition laws that exist under the Broadcasting Ordinance and the Telecommunications Ordinance and introduces a new cross-sector competition law. The new law prohibits three categories of conduct:

- The **First Conduct Rule** prohibits undertakings (a broad term encapsulating any entity engaged in commercial or economic activities) from engaging in agreements, concerted practices or decisions with the object or effect of preventing, restricting or distorting competition in Hong Kong;
- The **Second Conduct Rule** prohibits undertakings with a substantial degree of market power from abusing that power by engaging in conduct which has the object or effect of preventing, restricting or distorting competition in Hong Kong; and
- The **Merger Rule** prohibits undertakings from directly or indirectly carrying out a merger that has, or is likely to have the effect of substantially lessening competition in Hong Kong. Initially, the Merger Rule will only apply to telecommunications related mergers.

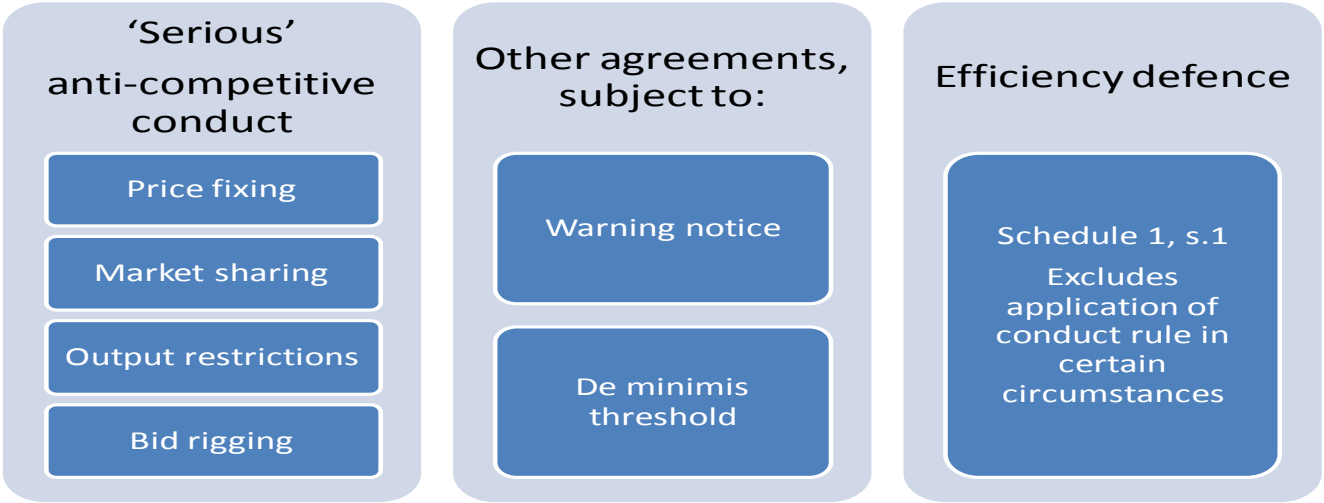
The First and Second Conduct Rules are known collectively as the "Conduct Rules". The Conduct Rules and the Merger Rule are collectively known as the "Competition Rules".

The law applies to "undertakings". The term is not defined in the CO. However, if overseas precedent is followed, an undertaking will not be defined by corporate identity, but rather by whether the companies, together, can be regarded as forming "one economic unit". This is usually fact dependent. However, generally, if there is a high degree of operational and financial control between two or more entities they will be considered part of the same undertaking. For example, wholly owned subsidiaries and the parent holding company would, together, usually be considered a single undertaking.

The law also introduces a further prohibition, the "Telco Rule", which prohibits excessive pricing by telecommunications licensees. This rule is being brought in by way of amendment to the Telecommunications Ordinance (the newly introduced section 7Q).

First Conduct Rule (multi-party conduct)

Overview



The First Conduct Rule distinguishes between two different categories of conduct: (i) what is referred to as "**serious anticompetitive conduct**" (price-fixing, market sharing, output controls and bid-rigging), and (ii) **other agreements** (explained below).

The prohibition applies not just to formal agreements, but also to looser forms of co-ordination between undertakings, including informal arrangements, "gentleman's agreements", concerted practices and tacit or expressly agreed co-ordination of conduct. Decisions and actions of trade associations and professional bodies are also within this scope. (We use the short-hand "agreements" in this briefing).

The law is not clear on how the concept of an "undertaking" will be defined. Accordingly, until the concept is clarified in the Guidelines and case law there will be uncertainty as to whether intra-group agreements between parent and subsidiary or two subsidiaries under common control will be caught and, if so, in what circumstances.

Serious anti-competitive conduct

The CO states that the following will be considered "serious" anti-competitive conduct:

1. **price-fixing**
2. **market sharing**
3. **output restrictions**
4. **bid-rigging**

For cases which are deemed to be serious anti-competitive conduct, no warning notice will be issued prior to prosecution although, for some cases, the Competition Authorities may issue an Infringement Notice allowing an opportunity to confess and enter into commitments. Businesses are not protected from follow-on actions if they take this course and admit to a contravention.

An important issue that has not been clarified is whether these "hard core" prohibitions will be applied just to agreements between competitors or whether they will extend to certain distribution agreements between manufacturers/distributors and retailers, such as **resale price maintenance** agreements (see below discussion on vertical agreements).

There is no *de minimis* protection from prosecution for serious anti-competitive conduct for SMEs.

Serious anti-competitive conduct is likely to attract the most significant penalties under the new law and to be the focus of the Competition Authorities' enforcement priorities, assuming overseas best practice is followed in Hong Kong.

Other agreements

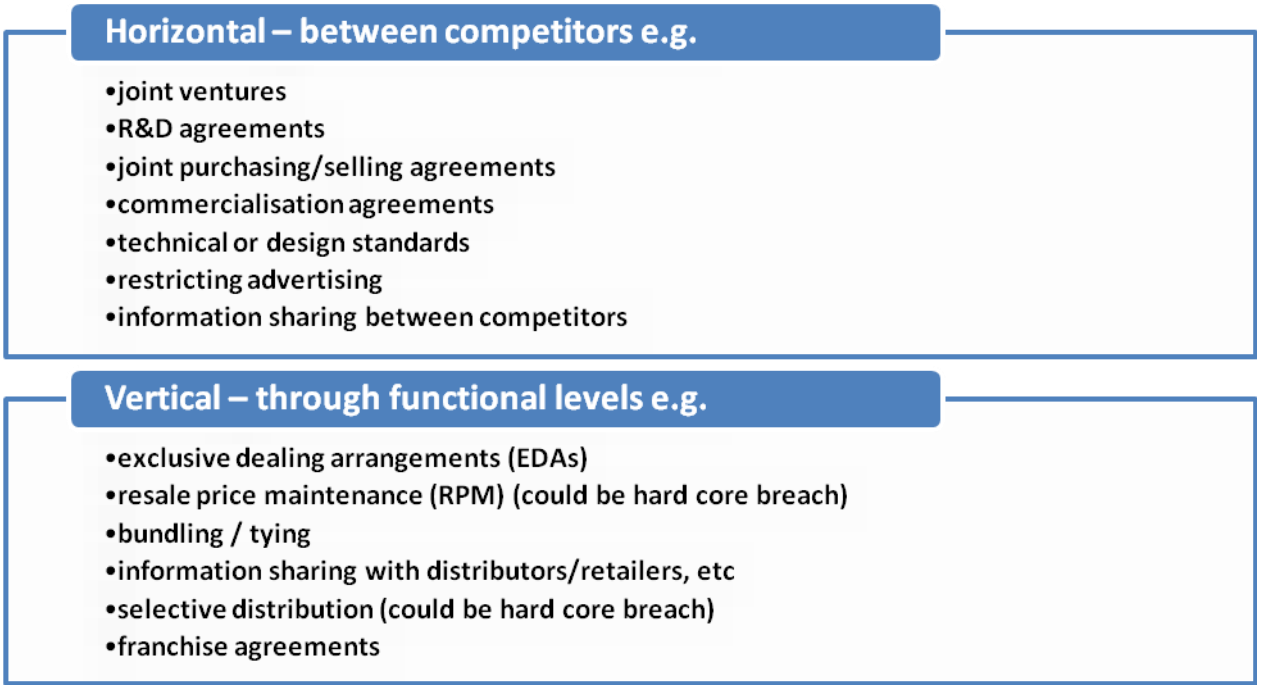
Commercial agreements between undertakings that are not considered "serious anti-competitive conduct" will be subject to a warning notice before prosecution. The notice is required to identify the conduct said to be in breach, what steps need to be taken to stop the conduct and the time period the undertakings have to comply (warning period).

Although the warning notice mechanism may give some comfort, there is likely to be dispute in many cases as to whether the conduct is anti-competitive. If the undertakings involved choose not to comply with the warning notice, they will be at risk of prosecution for their conduct from the time the warning period expired.

A wide range of commercial conduct could be caught under this category, including agreements with competitors that do not fall under the definition of "serious anti-competitive conduct", and agreements between manufacturers, distributors and retailers (what are usually referred to as "vertical agreements").

Only agreements that have the effect of preventing, restricting or distorting competition in a market in Hong Kong are in breach. However, there is significant cost and uncertainty for businesses in trying to assess this.

The Administration was called on during the Bills Committee debate to clarify the scope of the prohibition and, importantly in terms of the regulatory burden, whether vertical agreements (which are generally pro-competitive) would be carved out, following the Singapore approach. An important aspect of this is whether vertical price agreements such as resale price maintenance agreements (which could be classified as "serious anticompetitive conduct") are at risk. Unfortunately, this remains unclear and, for the time being, it should be assumed that a broad range of commercial agreements could, *prima facie*, come within the prohibition. Examples include:



Until there is more clarity, businesses will need to assume this prohibition is broad and should review both horizontal and vertical agreements for potential risks of breach, with a focus on the above categories of conduct.

There is *de minimis* protection from prosecution under this category where the combined annual turnover of the undertakings involved does not exceed HK$200 million.

Second Conduct Rule (single firm conduct)

The second conduct rule prohibits undertakings with a substantial degree of market power from abusing that power by engaging in conduct which has the object or effect of preventing, restricting or distorting competition in Hong Kong.

The CO highlights predatory pricing and "limiting production, markets or technical development to the prejudice of consumers" as particular conduct that could comprise a breach. However, the rule does not provide much guidance to businesses as to the conduct that may ultimately breach the law.

Abuse of dominance is a difficult concept to define in practice. The line between aggressive (but healthy) competition and abuse is very fine and sometimes very difficult to assess in advance of a court ruling.

A potentially wide range of conduct could cause an undertaking to be in breach, including:

Predatory pricing	•Charging prices which are below cost to drive a competitor from the market or prevent entry
Discriminatory pricing	•Charging different prices to similarly placed customers, or the same prices to differently placed customers
Fidelity pricing (or discounting)	•Making the prices of goods or services, or the availability of discounts dependent on retaining all or part of a customer's business
Refusal to supply	•Refusing to supply goods or services (or refusing to supply them except on clearly unacceptable terms)
Exclusivity (exclusive dealing)	•Requirement that the buyer will only buy goods from the seller
Bundling / tying	•Making the purchase of one product which the buyer wants conditional on the purchase of another unconnected product

As a rule of thumb, regulators in other jurisdictions tend to be heavily influenced by the commercial rationale for the conduct. If there are good commercial reasons for taking a certain course, it is less likely to be argued that the conduct has been engaged in for the purposes of foreclosing or otherwise lessening the intensity of competition in a market.

Unfortunately, even this rule of thumb is not easy to apply and businesses with strong market share may need to seek advice on significant aspects of their operations, to ensure they are aware of the potential risk of breach under this prohibition.

No warning notice will be issued before prosecution under the second conduct rule although the Competition Authorities may issue an Infringement Notice in some case allowing an opportunity to confess and enter into commitments. Businesses are not protected from follow on actions if they take this course and admit to a contravention.

There is *de minimis* protection from prosecution under this head where the turnover of the undertaking involved does not exceed HK$40 million.

Conclusion

The new law introduces to many sectors of the economy competition law prohibitions of a sort not seen before in Hong Kong. Those prohibitions remain unclear until they are shaped by appropriate guidelines, block exemptions and decisions from the Competition Authorities, the Competition Tribunal and the Courts. It remains to be seen whether this new law will increase Hong Kong's competitiveness or whether it will simply add a layer of regulatory cost and uncertainty. The answer to this will lie in how well the law is interpreted and applied, and whether this will be done in a manner consistent with Hong Kong's unique market policy.

Contacts

Hong Kong

Stephen Crosswell
T: +852 2826 3456
E: stephen.crosswell@cliffordchance.com

Martin Rogers
T: +852 2826 2437
E: martin.rogers@cliffordchance.com

China

Ninette Dodoo
T: +86 106535 2256
E: ninette.dodoo@cliffordchance.com

Emma Davies
T: +86 212320 7215
E: emma.davies@cliffordchance.com

United States

William Blumenthal
T: +1 202 912 5165
E: william.blumenthal@cliffordchance.com

Global

Oliver Bretz
T: +33 14405 5216
E: oliver.btetz@cliffordchance.com

Thomas Vinje
T: +32 2533 5929
E: thomas.vinje@cliffordchance.com

Clifford Chance, 28th Floor, Jardine House, One Connaught Place, Hong Kong

www.cliffordchance.com