

The final mile: long awaited draft competition law guidelines published

On 9 October 2014, Hong Kong's Competition Commission ("Commission") published a suite of six draft guidelines ("Guidelines") which offer guidance on how the Commission will interpret and enforce the Competition Ordinance ("Ordinance").

This briefing outlines some high-level points of interest covered in the Guidelines.

Background

The Ordinance was passed by the Legislative Council ("**LegCo**") on 14 June 2012 and it is being implemented in phases (see timeline diagram below). The publication of the Guidelines (which is required by the Ordinance) is an important step in the Commission's preparatory work towards the full implementation of the Ordinance – which is expected in May 2015.

The six Guidelines are listed below. The first three relate to substantive rules ("**Substantive Guidelines**"), whilst the other three relate to procedural/enforcement rules ("**Procedural Guidelines**"):

- a) Guideline on the First Conduct Rule;

Key issues

- The Commission has set out in detail how it proposes to enforce the Competition Rules when they come into force next year
- The Guidelines confirm that the First Conduct Rule will apply to vertical agreements and that the Commission will consider resale price maintenance (RPM) as serious anti-competitive conduct. Certain practices such as monitoring customers' resale prices or marking the resale price on a product may also be treated as RPM
- The Guidelines confirm that most forms of vertical agreement will only give rise to competition concerns where one or both parties have market power, although there is no guidance to suggest what level of market share might constitute market power in these circumstances
- The Second Conduct Rule applies only to undertakings which have "substantial market power". The Guidelines do not contain any market share thresholds to suggest when an undertaking might be treated as having substantial market power
- The Guidelines underline the importance to companies of assessing the economic and legal context in which they operate. Agreements which enhance overall economic efficiency are exempt from the First Conduct Rule, although the Guidelines make it clear that this exemption should be treated as a defence, with the burden of proving the efficiency falling on the undertaking

- b) Guideline on the Second Conduct Rule;
- c) Guideline on the Merger Rule;
- d) Guideline on Complaints;
- e) Guideline on Investigations; and
- f) Guideline on Applications for a Decision, Exclusions and Exemption and Block Exemption Orders.

The deadline for comment on the Procedural Guidelines is 10 November 2014 and on the Substantive Guidelines is 10 December 2014.

The Ordinance prohibits three forms of anticompetitive conduct:

- a) agreements between undertakings¹ that have the object or effect of preventing, restricting or distorting competition in Hong Kong ("**First Conduct Rule**");
- b) undertakings with a substantial degree of market power must not abuse that power by engaging in conduct which has the object or effect of preventing, restricting or distorting competition in Hong Kong ("**Second Conduct Rule**"); and
- c) mergers that have or are likely to have the effect of substantially lessen competition in Hong Kong ("**Merger Rule**" together abbreviated as "**Competition Rules**").

Agreements and conduct which take place outside Hong Kong, may be caught by the Ordinance so long as these have the object or effect of preventing, restricting or distorting competition in Hong Kong.

The above three competition rules are subject to a number of exclusions and exemptions which are summarised in the attached Annex.

Substantive Guidelines

The following paragraphs outline some high-level

points of interest in the Substantive Guidelines.

I. Vertical agreements

While it has been clear for some time that the First Conduct Rule would apply to horizontal agreements (agreements between competing undertakings), there was some uncertainty as to whether it would apply to vertical agreements (agreements between undertakings operating at different levels of the supply chain – for instance a wholesaler and retailer). It is now clear that vertical agreements are caught by the First Conduct Rule.

The Guidelines recognise that as a general matter, competition concerns only arise in relation to vertical agreements where there is some degree of market power at either the level of the supplier, the buyer or at the level of both. However, in contrast to the approach adopted in some other jurisdictions, the Guidelines do not go on to indicate how much "market power" is required for concerns to be raised – except to say that vertical agreements between small and medium enterprises ("**SMEs**") would rarely be capable of harming competition.

The Guidelines single out resale price maintenance ("**RPM**") – defined as setting a fixed or minimum resale price – as being the most likely type of vertical restraint to have the object of preventing, restricting and distorting competition. The Commission indicated that it may treat RPM as "Serious Anti-Competitive Conduct" which means that the exclusion for agreements of lesser significance does not apply and the Commission is not required to issue a warning notice before bringing proceedings for breach of the Ordinance.

This approach is consistent with the approach in the European Union ("**EU**") but a departure from the approach in Singapore, where vertical arrangements are deemed to be generally efficiency enhancing and exempt from the application of the prohibition against anti-competitive agreements. Some examples of how RPM may restrict competition include by facilitating coordination between competing suppliers (through enhanced price transparency), by undermining suppliers' incentives to lower prices to distributors; and by limiting "intra-brand" price competition.

¹ The term "undertaking" is defined in section 2(1) of the Ordinance as any entity (including a natural person) regardless of legal form which is engaged in an economic activity.

The Commission will permit the setting of recommended or maximum resale prices – provided these do not result in anti-competitive effects. However, the Guidelines indicate that the use of price monitoring systems or printing a recommended resale price on a product may be indicative that a recommended/maximum resale price is in reality a fixed or minimum prices and so will be treated by the Commission as RPM. This could raise some concerns in the retail sector in particular where such practices are not uncommon.

In addition, exclusive distribution and customer allocation agreements are also permitted – provided these do not result in anti-competitive effects.

II. Concerted practices

The Ordinance states that the First Conduct Rule applies to agreements and "concerted practices" – but does not define this term. The Guidelines define concerted practice as a form of cooperation, falling short of an agreement, where undertakings knowingly substitute practical cooperation for the risks of competition. This definition is consistent with the EU approach. In practice, however, there is a fine line between determining what amounts to a concerted practice (which is unacceptable) on the one hand, and parallel behaviour (which is acceptable) on the other, for instance, where competitors respond to each other's pricing in the market. This can be an issue of particular concern in markets where price is driven by the cost of an underlying commodity such as oil – airlines and petrol forecourts being typical examples of markets where this difficulty can arise.

III. Information exchange

The Guidelines state that the Commission will consider exchanges of information between competitors on future prices and quantities (and possibly some other information, such as market shares) as having the object of restricting competition. This means that there will be no requirement on the Commission to show that the exchange of information has any anti-competitive effect. Moreover, the exchange of other types of information might also infringe the First Conduct Rule if it has an anti-

competitive effect or potential effect. The Guidelines also confirm that even an indirect exchange of information can breach the First Conduct Rule – for example by competitors providing information to a common supplier or customer. The Commission may need to elaborate further on the circumstances in which this behaviour might be unlawful – especially given interactions with customers or distributors on competitor pricing are commonplace during the bargaining or negotiation process.

IV. Standard terms

The Guidelines also cover standard terms such as those commonly found in the insurance and banking sector. Standard terms relating to price will generally be considered as harmful to competition. In addition, standard terms which define the nature of, or relate to the scope of, the product (e.g. standard terms concerning risks to be covered by a particular category of insurance policy) could result in limiting product variety and innovation – and thereby be seen as anti-competitive by the Commission.

The Guidelines also state that where a trade association develops standard terms which are vital to enable new entrants to access a market, prohibiting access to those terms would breach the First Conduct Rule.

V. Significant market power

The Second Conduct Rule prohibits "abusive" behaviour by undertakings with a substantial degree of market power. The Guidelines state that undertakings are more likely to have a substantial degree of market power where they have high market shares. However, there is no indication of what constitutes a high market share. In the EU and Mainland China, an undertaking with a market share of 50% and above is presumed dominant; and in Singapore the threshold is 60% and above. During the early stages of the consultation process regarding the Ordinance, previous discussions within the Hong Kong Government indicated that the intention behind applying a "significant market power" test as opposed to a "dominance" test was that it implied a lower threshold (suitable for a small economy like Hong

Kong) where undertakings with significant market power could possess market shares of 25%. However, it is interesting to note that the Guideline on the Merger Rule refers to a figure of 40% as a level below which no further investigation will typically be necessary (see below). Given previous discussions (and given the additional rules and prohibitions that apply to undertakings with significant market power), it would be helpful for the Commission to provide some clarity in relation to a market share threshold for significant market power.

Whatever market share threshold is used to determine the presence of market power, in defining the relevant market, the Guidelines indicate that the Commission will not generally consider supply-side substitutability or potential competition when defining the relevant market. This is a departure from the approach adopted in jurisdictions such as the EU and mainland China and could lead in some cases to markets being defined more narrowly in Hong Kong than elsewhere.

VI. Exploitative conduct

The Ordinance prohibits "exploitative conduct" - defined as fixing and maintaining prices or charges at an excessively high level and setting unfair trading terms and conditions - by dominant telecommunications licensees. It is not clear if exploitative conduct (and especially excessive pricing) by businesses with significant market power in other sectors (other than telecommunications) will be caught by the Second Conduct Rule. This discussion is absent from the Guideline on the Second Conduct Rule. On the other hand, the Guideline lists "predatory pricing" (or setting very low prices) as an example of pricing conduct which may, in appropriate circumstances, be considered an abuse of a substantial degree of market power. Excessive pricing - which is the earning of monopoly profits - represents a more obvious harm to consumers. For this reason such conduct is caught by the abuse of dominance prohibitions in the EU, Singapore and Mainland China. It would be helpful for the Commission to clarify how exploitative conduct (and especially excessive pricing) will be treated by the Second Conduct Rule.

VII. Intellectual Property Rights

The Guidelines also set out the Commission's position regarding the compulsory licensing of intellectual property rights ("IPRs"). This issue is also under consultation in mainland China, where the State Administration of Industry and Commerce ("SAIC") published a revised set of draft rules in June 2014. Although both the Commission and SAIC indicate that there may be circumstances in which an undertaking can be compelled to license its IPR to a third party, the Commission has not followed SAIC's approach of requiring a licence to be granted for IPRs which constitute an "essential facility". Instead, the Guidelines indicate that a refusal to license IPR would breach the Second Conduct Rule only in exceptional circumstances where doing so would limit technical development resulting in consumer harm. Similarly, the Commission has not sought to extend the obligation to grant a licence on fair, reasonable and non-discriminatory ("FRAND") terms to all holders of standard essential patents, but (consistent with the EU approach) has indicated only that a refusal to offer FRAND terms may be an abuse when the patent holder had given a prior commitment to offer such terms at the time the IPRs were adopted as an industry standard.

VIII. Merger Rule

The Merger Rule is the only Competition Rule that does not apply across sectors. Rather, it only applies to a merger involving a telecommunications carrier licensee. However, of note is the fact that the Commission considers that where the merged firm has a market share of less than 40% and a post-merger combined market share of the top largest firms is less than 75% - it will take the view that it is unlikely that there will be a need to carry out an investigation or to intervene. Note that these thresholds simply confirm the position previously adopted by the Telecommunications Authority. It remains to be seen whether a similar threshold regarding market concentration will be applied in terms of assessing relevant markets in other situations - in particular in the context of the Second Conduct Rule.

Procedural Rules Guidelines

The Procedural Guidelines elaborate on how the complaints, decisions, block exemptions and investigations regimes will operate. Further guidance is expected in relation to the Commission's leniency policy, its enforcement priorities and the application of the Ordinance to SMEs.

The Guidelines allow the Commission to adopt block exemption orders and also to consider applications for a decision conferring immunity from action under the relevant Conduct Rule. However, the Commission is only required to consider an application under certain circumstances, including under the circumstance that the application poses novel or unresolved questions of wider importance or public interest in relation to the application of exclusions of exemptions under the Ordinance. The phrase "novel or unresolved questions of wider importance or public interest" is not defined in the Ordinance; neither has it been defined in the Guidelines.

Further guidance is expected in relation to the Commission's leniency policy, its enforcement priorities and the application of the Ordinance to SMEs.

Conclusion

The Guidelines are a welcome step towards the implementation of the Ordinance and contain over 200 pages of detail on how the Commission will interpret and apply the Ordinance upon its expected entry into force next year. Further guidance is expected in relation to leniency and the application of the competition rules to SMEs as well as a statement on the Commission's enforcement priorities.

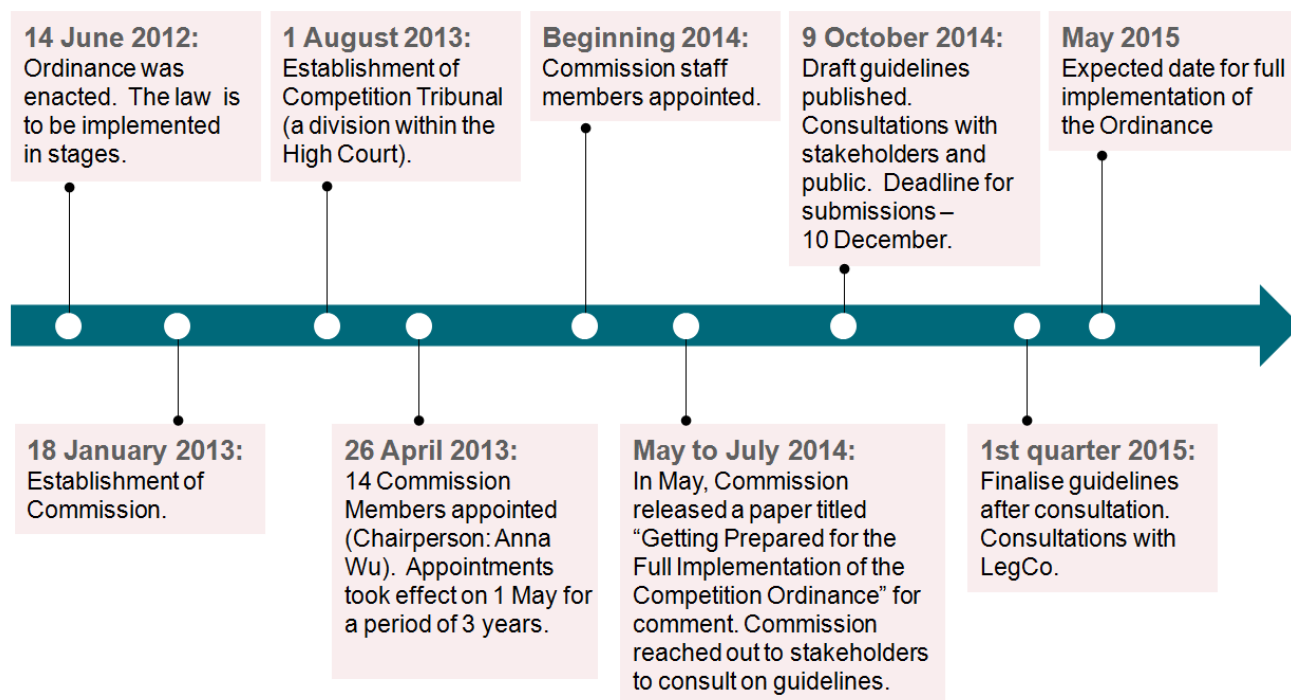
It is clear from the approach adopted in the current draft Guidelines that companies will be required to examine their conduct carefully in order to ensure compliance. The Commission has consciously chosen not to suggest market share thresholds below which an infringement is unlikely to occur, meaning that – except for companies with revenues of less than HK\$40 million (or HK\$200 million in aggregate) – the Guidelines provide no safe harbor thresholds. There are exclusions from the two Conduct Rules, although the Guidelines suggest these will be interpreted narrowly.

In particular, the Guidelines make it clear that the "efficiency exclusion" (which excludes agreements which enhance overall economic efficiency from the scope of the First Conduct Rule) should be treated as a defence where the burden of proving the efficiency lies with the undertaking seeking to assert the defence. Experience from other jurisdictions suggests that there will be relatively few cases where conduct is found to be anti-competitive, but can nevertheless escape sanction on the grounds of efficiency.

However, in the analysis of the various types of conduct that may be caught by the First Conduct Rule, the Guidelines refer frequently to the notion of efficiency – in the 59 pages of the Guideline on the First Conduct Rule, there are 100 mentions of the word "efficiency" (or derivations of it). This suggests there may be many cases where it is not straightforward to determine the legality of an agreement without also assessing whether that agreement leads to efficiencies.

Consequently, the absence of clear market share thresholds risks placing an undue burden on companies to prove that their conduct is lawful.

Competition Ordinance – Timeline



Annex

Relevant exclusion or exemption	First Conduct Rule	Second Conduct Rule	Merger Rule
Agreements enhancing overall economic efficiency	✓	✗	✓
Compliance with legal requirements	✓	✓	✗
Services of general economic interest	✓	✓	✗
Mergers	✓	✓	NA
Agreements of lesser significance	✓	✗	✗
Conduct of lesser significance	✗	✓	✗
Block exemption orders	✓	✗	✗
Public policy exemption	✓	✓	✓
International obligations exemption	✓	✓	✗
Statutory body and specified person or activities exclusions	✓	✓	✓

Agreements of lesser significance are defined as:

- (a) an agreement between undertakings in any calendar year if the combined turnover of the undertakings in the preceding year does not exceed HK\$200 million;
- (b) a concerted practice engaged in by undertakings in any calendar year if the combined turnover of the undertakings in the preceding year does not exceed HK\$200 million; or
- (c) a decision of an association of undertakings in any calendar year if the turnover of the association in the preceding year does not exceed HK\$200 million.

Conduct of lesser significance is defined as: conduct engaged in by an undertaking the turnover of which does not exceed HK\$40 million in the preceding year.

Turnover for these purposes means the total gross revenues of an undertaking whether obtained in Hong Kong or outside Hong Kong.

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