**For discussion**
**on 6 December 2011**

# Bills Committee on Competition Bill

## Responses to follow-up questions arising from previous meeting

## Purpose

This paper responds to questions raised by Members at the meeting of 8 November 2011.

## A. Second conduct rule

2. The reasons for not specifying a market share in the law for assessing the degree of market power under clause 21 of the Competition Bill (the Bill) have been set out in our previous submissions, including Paper No. CB(1)389/11-12(02). We are nevertheless open to suggestions that would increase the clarity in the operation of the competition law. One suggestion raised by Members involves making reference to a percentage figure during the Second Reading debate to explain our policy intent. We would give further consideration to this and other effective options.

## B. De minimis thresholds for the second conduct rule

3. The underlying rationale of setting the de minimis threshold at $11 million for the second conduct rule of the Bill is that conduct of an undertaking with an annual turnover below the average of the small and medium enterprises (SMEs) is unlikely to have an appreciable adverse effect on competition. Lifting the threshold would exclude more undertakings from the application of the second conduct rule, and the future competition authorities could not take out any enforcement action against them even if the excluded undertakings abuse their market power to restrict competition appreciably in a market. Hence, we must be prudent in considering any adjustment to the threshold. Nonetheless, we have heard concerns expressed by Members and are considering whether there are other options which would not undermine the effectiveness of the law in tackling anti-competitive conduct.

4. There was suggestion that the de minimis threshold for the second conduct rule be replaced by the listing requirements[1]. The three financial criteria for listing on the Main Board of the Hong Kong Exchange (HKEx) are meant for evaluating the financial viability of the companies capable of seeking capitalization in the market. These are completely different from the reason justifying the de minimis threshold. Adopting de minimis thresholds as high as the listing requirements would effectively mean that only undertakings which are qualified for listing on the Main Board of the HKEx would be subject to the Bill. This runs contrary to the intention of providing de minimis arrangements under the second conduct rule to exclude smaller companies from the regime since they are unlikely to possess market power in any given market. The adoption of listing requirements as the de minimis threshold would also have the effect of excluding the vast majority of, or even all, undertakings in the relevant market. This would significantly reduce the scope of application of the second conduct rule and severely affect the overall effectiveness of the Bill.

5. As regards aggregate data on the level of turnover of companies paying profits tax, the Inland Revenue Department does not collate such statistics.

## C. Vertical constraints

6. The recent incidents of suspected anti-competitive conduct in the retail and wholesale sector smack of a typical case of resale price maintenance (RPM). If the supplier or distributor of a product determines or fixes the resale price of the product through vertical arrangements binding on the

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[1] According to the Hong Kong Exchange and Clearing Limited, a new applicant for listing equity securities on the Main Board of the Exchange must have a trading record of not less than three financial years and meet one of the following three financial criteria:

(1) ***Profit Test***: at least HK$50 million profit attributable to shareholders in the last three financial years (with profits of at least HK$20 million recorded in the most recent year, and aggregate profits of at least HK$30 million recorded in the two years before that), and a market cap of at least HK$200 million at the time of listing.

(2) ***Market Cap/ Revenue Test***: at least a market cap of HK$4 billion at the time of listing, and a revenue of at least HK$500 million for the most recent audited financial year.

(3) ***Market Cap/ Revenue/ Cashflow Test:*** at least a market cap of HK$2 billion at the time of listing, a revenue of at least HK$500 million for the most recent audited financial year, and a positive cashflow from operating activities of at least HK$100 million in aggregate for the three preceding financial years.

retailers, this would have the effect of restricting competition amongst the retailers of the same brand in the downstream market and might constitute a contravention under the first conduct rule in the Bill. In overseas jurisdictions such as the EU and the UK, RPM agreements are not immune from the competition law because the block exemption for vertical agreements does not apply to RPM cases. **Appendix A** summarises two overseas cases of RPM agreements for Members' reference. As for the reported allegations that the vertical constraints on smaller retailers by suppliers were imposed in response to pressure from larger retailers with market power, depending on the extent of the restrictions imposed and the degree of market power of the large retailers, such conduct may also amount to an abuse of a substantial degree of market power under the second conduct rule of the Bill.

## D. Grant of block exemption orders in overseas jurisdictions

7. In competition jurisdictions such as the EU, Singapore and the UK, decisions of the authorities to vary or revoke block exemption orders for certain agreements are subject to review by the court or a designated appeal body. For example, in Singapore the decision for or in relation to the cancellation of a block exemption in respect of an agreement is appealable before the Competition Appeals Board. In the UK, an appeal against the decision of the Office of Fair Trading on the cancellation of a block exemption lies before the Competition Appeals Tribunal. As for the EU, the European Commission's decisions, including those relating to block exemptions, are subject to review by the European General Court.

## E. Exclusions/ exemptions in overseas jurisdictions

8. The provisions relating to exemption on public policy grounds in clause 31 and exclusions by virtue of Schedule 1 of the Bill are modeled on similar provisions in competition laws of major overseas jurisdictions such as the EU, Singapore and the UK. A summary of some of the case law or example of the application of these exclusions or exemptions abroad is at **Appendix B**.

## F. Drafting issues

9. For the sake of consistency and clarity, we would propose amendments to the following provisions in Part 2 of the Bill:

(a) ***Clauses 7 & 22***: to add a subclause to both clauses to make clear that an agreement, concerted practice or decision/ conduct has an effect of preventing, restricting or distorting competition if one of its effects is to prevent, restrict or distort competition;

(b) ***Clause 27(2)***: to amend the Chinese text in subclause (2) "*如凡*有關決定在某些條件及限制的規限下具有效力，" in order to achieve consistency with similar phrase in clause 12(2);

(c) ***Clause 29(2)***: to amend the Chinese text in subclause (2) "在根據本條取消*任何*決定之前，" in order to achieve consistency with similar phrase in clause 14(2);

(d) ***Clause 29(7)***: to amend the Chinese text in subclause (7) "如競委會根據本條取消某決定，有關取消通知所指明的每一業務實體自該項取消*的*生效日期起，" in order to achieve consistency with similar phrase in clause 14(7);

(e) ***Clause 33(2)***: to amend the Chinese text in subclause (2) "*藉決議通過*修訂該命令" in order to achieve consistency with the phrase "by resolution passed" in the English text; and

(f) ***Clauses 33(3) & (5)***: to amend the Chinese text in subclauses (3) & (5) "，但在立法會下一*屆*會期的第二次會議之日或該日之前屆滿，" in order to enhance clarity of the English equivalent of "in the next session".

**Advice sought**

10. Members are invited to note the contents of the paper.

**Commerce and Economic Development Bureau**
**December 2011**

**Appendix A**

## Overseas case law on resale price maintenance

***Editions Nathan*** *– decision of the European Commission (EC) (5 July 2000) (Case COMP.F.1/36.516) [Official Journal of the EC L 54/1)*

- Editions Nathan is a French company producing educational material and school textbooks, mainly in France where Nathan is one of the market leaders. The agreements in question concern restrictive distribution agreements for educational material aimed at pre-school children with Nathan's three exclusive distributors in Italy, Sweden and the French-speaking parts of Belgium.

- The exclusive distribution agreements between Nathan and the distributors contain, inter alia, terms that restrict the distributors' freedom to set prices and commercial conditions of sale. When entering into the agreements, the distributors undertake to provide Nathan with a list of the prices at which the distributor is selling Nathan products on its territory. The prices shall not exceed the price at which Nathan sells the same products in France by certain percentage. While an obligation not to exceed a maximum resale price in itself does not necessarily restrict competition, the EC noted that the agreements between Nathan and its distributors has at the same time imposed a ban on all promotional discounts (e.g. special offers, discounts, rebates, clearance sales, etc), which, coupled with the price ceiling set by Nathan, effectively fix a resale price of the products at the maximum price level. For this reason, the EC found that the agreements concluded between Nathan and its three distributors have the object of restricting or distorting competition inasmuch as they are aimed at fixing resale prices.

- The EC also considered that neither the block exemption for vertical agreement nor the exclusion for agreements enhancing overall efficiency apply to the distribution agreements in question. The restriction on the distributors' freedom to determine their prices and discounts is not essential to improving the distribution of products. Furthermore, while the ban on discounts and special offers may be legitimate for maintaining a brand image, the objective can be attained by means that are less restrictive of the freedom of the parties concerned.

***Toys"R"us*** *– ruling of the United States District Court, Pennsylvania (July 2009) (Civil Action No. 06-0242)*

- During the early 1990s, retail giant Toys"R"us created Babies "R"Us (BRU), a retail chain specializing in baby products. Since then, BRU has dominated the market. But with the advent of internet technology, BRU soon faces stiff competition from retailers running E-commerce business that are able to offer huge discounts.

- The case concerns a class action alleging that BRU has contravened the anti-trust law by conspiring with various baby product manufacturers to restrict competition. BRU

was found to have coerced these manufacturers into preventing internet retailers from offering discounts. Specifically, BRU would threaten not to carry products unless their manufacturer agreed to prevent internet retailers from discounting them. BRU also pressured manufacturers by making increase in sales of the manufacturers' products by BRU contingent on the manufacturers' agreement to prohibit internet discounts.

- Manufacturers were forced to acquiesce because industry-dominant BRU had become their most prized customer. Manufacturers used various methods to prevent internet discounting, including resale price maintenance where manufacturer prohibits internet retailers from discounting too far below a suggested retail price. As a result, BRU has effectively prevented internet discounts to its benefit but harmed the internet retailers (without ability to discount), manufacturers (with fewer total sales), and consumers (with higher prices).

- The Court was satisfied that BRU was sufficiently dominant to coerce each manufacturer into preventing internet discounts. It noted that the vertical price restraints in this case could have anti-competitive effects and there are other less restrictive means of promoting inter-brand competition. In this case, the restraints do not promote inter-brand competition by helping manufacturers induce retailers to perform services or promote its brand, but rather support a dominant retailer by preventing retailers with lower cost structures from charging lower prices.

**Appendix B**

**Overseas examples of exclusion or exemption from the competition law on grounds similar to clause 31 and Schedule 1 of the Competition Bill**

***Clause 31: Exceptional and compelling reasons of public policy***

- In the UK where they have provision similar to clause 31 of our Bill (c.f. section 7 of Schedule 3 to the UK Competition Act 1998), the Secretary of State has so far made three statutory orders to grant exclusion from the competition law to specific agreements for exceptional and compelling reasons of public policy.

- All three agreements relate to national defence and security, covering the provision and maintenance of nuclear submarine and nuclear reactor, the development of strategic or tactical weapon, and the maintenance and repair of warships.

***Section 1 of Schedule 1: Agreement enhancing overall economic efficiency***

***Visa International*** *- decision of European Commission (EC) (24 July 2002) (Case No. COMP/29.373) [Official Journal of the EC L318/17)*

- The case concerns a review of the various rules and regulations governing the Visa association, including whether the Visa EU multilateral interchange fee (MIF) scheme may be exempted under Article 101(3) of the Treaty of the Functioning of the European Union (TFEU) (which is similar to section 1 of Schedule 1 to the Bill).

- In the absence of a bilateral interchange agreement between banks, the MIF applies to all EU intra-regional Visa card transactions which is set by Visa EU Board as a percentage of net sales, being a remuneration paid between banks for the settlement of a card payment transaction. According to Visa, the MIF is necessary as a financial adjustment to the imbalance between the costs associated with issuing and acquiring and the revenues received from cardholders and merchants for cross-border Visa consumer card transactions.

- The EC found the MIF scheme an agreement between competitors which restricted the freedom of banks individually to decide their own pricing policies and distorted competition on the Visa issuing and acquiring markets. Following its finding, the EC considered that the scheme fulfilled the conditions for an exemption under Article 101(3) TFEU for the following reasons –

  (a) The Visa network is characterized by network externalities: the more merchants in the system, the greater the utility to cardholders and vice versa. It generates positive network effects, namely the existence of a large-scale international payment system. The proposed MIF could lead to reduced costs for merchants and may lead to more merchants accepting Visa cards, which would be in the interest of cardholders. The EC concluded that the MIF contributes to technical and economic progress, while providing a fair share of

these benefits to each of the two categories of user of the Visa system, and thus meets the first and the second conditions of Article 101(3).

(b) The EC was content that the proposed MIF can be considered as indispensable since in the absence of a direct contractual relationship between issuers and merchants, without some kind of multilateral interchange fee arrangement, it would not be possible for issuers to recover from merchants the costs of services which are provided ultimately to the benefit of merchants. It also accepted that the MIF is the least restrictive of competition out of all the possible types of MIF.

(c) Lastly, the EC noted that the MIF does not eliminate competition between issuers, which remain free to set their respective client fees. The acquiring banks also remain free to set the merchant fees and can still compete on the other components of the merchant fee apart from the MIF. Nor does it eliminate competition between Visa and its competitors. Hence, the MIF fulfils the fourth condition of Article 101(3).

***Section 2 of Schedule 1: Compliance of legal requirements***

***Vodafone** – ruling of the Director General of Telecommunications UK (April 2002)*

- The case concerns an allegation that Vodafone's distribution agreement for pre-pay mobile phone vouchers (the Distribution Agreement) with a number of distributors to fix the retail prices at the face value infringes the prohibition on anti-competitive agreement under section 2(1) of the UK Competition Act 1998. Paragraph 5(1) of Schedule 3 to the Competition Act provides that the prohibition does not apply to an agreement to the extent to which it is made in order to comply with a legal requirement.

- Under the terms of the Distribution Agreement, the distributors must sell pre-pay mobile phone vouchers at their face value. Certain clauses in the agreement also prevent sub-distributors and retailers from re-selling vouchers at prices other than the face value. The competition authority considered that the clauses in the Distribution Agreement explicitly and directly fix the resale prices of pre-pay mobile phone vouchers and prima facie has the object of preventing, restricting or distorting competition.

- Condition 58.3 of Vodafone's licence under the Telecommunications Act requires that Vodafone shall "provide… services… at the charges, terms and conditions so published, and shall not depart therefrom…". The competition authority considered that Condition 58.3 requires that Vodafone's standard distributor agreements to be drafted so as to ensure that vouchers are sold to the customer (end user) at Vodafone's published prices, i.e. at their face value, or otherwise a customer could receive mobile airtime for more, or less, than the published price.

- The competition authority concluded that, to the extent that Condition 58.3 applies, the prohibition in section 2(1) of the Act is disapplied under paragraph 5(1) of Schedule 3 of the Competition Act, because the Distribution Agreement is drafted so

as to ensure compliance with a requirement imposed by or under any enactment in force in the UK.

## ***Section 3 of Schedule 1: Services of general economic interest***

***Deutsche Post AG** – decision of the European Court of Justice (ECJ) (10 February 2000) (Case C-147/97) [ECR I-825)*

- The case concerns a dispute between Deutsche Post AG and two other undertakings over the delivery of post from abroad. Under the Universal Postal Convention (UPC), the postal services of a Contracting State are obliged to forward and deliver to the relevant addressees international letter-post items addressed to persons resident in its state passed to them by the postal services of other Contracting States. In addition, Article 25 of the UPC (now Article 27) provides that a member country shall not be bound to forward or deliver to the addressee letter-post items which senders resident in its territory post or cause to be posted in a foreign country with the object of profiting by the lower charges there.

- Deustche Post has been granted exclusive rights as regards the collection, carriage and delivery of mail in Germany and holds a dominant position within the meaning of Articles 102 TFEU (concerning the prohibition against the abuse of dominance).

- One of the issues to be considered by the ECJ was whether it is contrary to Article 106[Note], read in conjunction with Article 102, for Deutsche Post to exercise the right provided for under the UPC to charge internal postage on items of mail posted in large quantities with the postal services of another Member State.

- The ECJ concluded that the conduct of Deutsche Post did not run contrary to Article 106 for the following reasons –

  (a) Having regard to the UPC which guarantees the freedom of transit of reciprocal international mail, the ECJ considered that for the postal services of the Member States, performance of obligations flowing from the UPC is thus in itself a service of general economic interest within the meaning of Article 106.

  (b) The grant to a body such as Deutsche Post of an exclusive right creates a situation where that body may be led, to the detriment of users of postal services, to abuse its dominant position resulting from its exclusive right. In the present case, the ECJ considered that Deutsche Post has been entrusted by legislation with the operation of the services of general economic interest.

[Note] Article 106 TFEU, inter alia, provides that in the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in the Treaties, in particular to those rules provided for in Article 18 and Articles 101 to 109. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in the Treaties, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them.

The exercise of the exclusive right to treat international items of mail as internal post is necessary to enable Deutsche Post, for the purposes of the performance, in economically balanced conditions, of the task of general interest entrusted to Deutsche Post by the UPC. This means that Deutsche Post would not be able to carry out its obligation to operate a service of general economic interest without engaging in the alleged abusive conduct. It must therefore be justified for Deutsche Post to treat cross-border mail as internal mail and consequently to charge internal postage.