# Competitive Edge

Local developments and international trends relevant to Hong Kong and China

March 2008

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# Regional Developments

## Merger control in China - Your compliance starts .... now

**Key points:**

- The introduction of China's new Anti-Monopoly Law has led many businesses to focus attention on preparing for commencement of the law on 1 August 2008.
- In the interim, it remains equally important for businesses to ensure they comply with China's existing competition laws, including the merger control regime under China's *Regulations for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*.
- Under this regime, foreign businesses are required to report a broad spectrum of 'inbound' and 'offshore' transactions to China's Ministry of Commerce (and other bodies). However, the regime has been largely ignored by some - perhaps due to the absence of a clear mechanism to penalise non-compliance.
- The Anti-Monopoly Law includes a new merger control regime, which empowers the relevant enforcement body (likely to be staffed by personnel from the Ministry of Commerce) to impose significant fines and other penalties on non-compliant parties. Accordingly, businesses are likely to benefit from demonstrating observance with the existing merger control regime prior to commencement of the Anti-Monopoly Law.

Since the promulgation of China's new Anti-Monopoly Law on 30 August 2007, many businesses with activities or affiliates in China have focused their attention on the law and how it may impact on their activities. As it is expected that the law will be an enforcement priority for relevant China authorities after it commences on 1 August 2008, it is understandable that businesses are prioritising preparations for compliance with the law.

However, it is also prudent to remember that China has a number of existing competition laws, including a relatively far-reaching merger control regime. While China's current operative competition laws are somewhat fragmented, and have not always been rigorously enforced, it is likely that certain of those laws will be applied with increasing vigour in the lead-up to commencement of the Anti-Monopoly Law.

In this context, this article aims to provide a brief overview of the merger control regime currently in force in China under the *Regulations for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (hereafter referred to as the "**M&A Regulations**").

***About the M&A Regulations***

Under the M&A Regulations, relevant merger and acquisition transactions may be reviewed by MOFCOM and the State Administration of Industry and Commerce (SAIC), and a determination made as to whether (as per Articles 51 and 52) those transaction will cause "excessive concentration in the domestic market, impede fair competition, and harm the interests of domestic consumers". Article 3 also generally requires that such transactions "not cause excessive concentration, or exclude or restrict competition".

It appears that the key regulatory body charged with administering and enforcing the M&A Regulations, the Ministry of Commerce ("**MOFCOM**"), is applying the existing merger control regime with increasing diligence in the lead up to commencement of the Anti-Monopoly Law. Accordingly, businesses would be well advised to ensure they are aware of, and compliant with, their obligations under the regime.

*The scope of the existing merger control regime*

Unlike the merger control regime that will apply under the Anti-Monopoly Law, the M&A Regulations do not cover merger and acquisition transactions between Chinese companies who are not foreign-invested. However, they do apply to what we may term 'inbound' and 'offshore' transactions involving foreign (i.e. non-Chinese) parties.

Article 2 of the M&A Regulations states that they cover mergers and acquisitions between foreign investors and domestic Chinese enterprises (hereafter referred to as 'inbound' transactions) of two types - equity transactions and asset transactions.

The equity transactions covered are:

* a foreign investor's acquisition of equity interest in a purely domestic enterprise and the subsequent conversion of that domestic enterprise into a foreign owned enterprise (FIE), and
* a foreign investor's subscription to the increased capital of a purely domestic enterprise and subsequent conversion of that domestic enterprise into an FIE.

The asset transactions covered are:

* a foreign investor's establishment of an FIE to acquire and use the assets of a domestic enterprise (including those of an FIE), and
* a foreign investor's direct acquisition of the assets of a domestic enterprise (including those of an FIE) and contribution of those assets to establish and operate an FIE.

'Offshore' transactions are dealt with by Article 54, which uses the term 'overseas merger or acquisition' but leaves this term undefined. No guidance is provided as to what level of control must be acquired over a target entity before the transaction constitutes an 'overseas merger and acquisition' for this purpose. Accordingly, the term could potentially cover any level of acquisition occurring outside of China.

*Reporting thresholds*

The M&A Regulations mandate reporting of relevant inbound and offshore transactions to MOFCOM and the SAIC if certain thresholds are met by the transaction parties.

Reporting of an inbound transactions is required if a party to the transaction (if foreign, including affiliated enterprises):

- has a one-year China business turnover exceeding 1.5 billion renminbi in the Chinese market for the current year;
- has in one year acquired more than 10 domestic enterprises in related industries; or
- has a market share of at least 20 per cent in China, or will have a market share of at least 25 per cent in China as a result of the inbound transaction.

Reporting of an offshore transactions is required if a party to the transaction (including affiliated enterprises):

- has assets over 3 billion renminbi in China;
- has a one-year China business turnover exceeding 1.5 billion renminbi in the Chinese market for the current year;
- has a market share of at least 20 per cent in China, or will have a market share of at least 25 per cent in China as a result of the inbound transaction; or
- will hold (either directly or indirectly) shares in more than 15 foreign invested enterprises in the relevant industry in China as a result of the transaction.

As the asset and China turnover thresholds in relation to offshore transactions are quite low, large multinational companies with significant investment in China are likely to meet the filing threshold and thus may be required to report all of their offshore transactions.

*What needs to be reported, and when?*

In relation to inbound transactions, Guidelines issued by the Anti-trust Investigation Office of MOFCOM stipulate that reporting is required before public announcement of the transaction. In addition, the parties will often be required to submit their report (and perhaps evidence of

clearance) in order to obtain required foreign investment approvals and registrations.

The M&A Regulations expressly require that the parties to a reportable offshore transaction notify MOFCOM or SAIC of their merger plan before it is publicly announced, or at the same time that it is submitted to the regulatory authorities of the country in which the transaction will occur.

In relation the content of report filings, the Guidelines provide a detailed list of information that should be included, which includes basic particulars of the parties to the transaction, descriptions of the enterprises and individuals affiliates with the parties, an overview of the transaction, definition of the relevant market, sales turnover and market share information, and information on key competitors and the supply and demand structure in the relevant market.

The Guidelines also require that a number of official documents be provided with the filing, such as proof of the identity or registration of the reporting party, and approval certificates and business licences for Chinese entities or representative offices relating to or relevantly affiliated with the transacting parties.

### *Grounds for exemption from anti-monopoly review*

The M&A Regulations stipulate that if a transaction meets one of the following criteria, a party to the acquisition may apply for review exemption:

- the acquisition may improve the fair competitive environment;
- the acquisition restructures loss making enterprises and ensures employment;
- the acquisition introduces advanced technology and management, and may enhance the enterprises' international competitiveness; or
- the acquisition may improve the environment.

### *The review process*

Article 52 of the M&A Regulations provides that, for onshore transactions, MOFCOM and SAIC may first determine that a transaction "might cause excessive concentration in the domestic market, impede or disturb rightful competition, and harm domestic consumers' benefits, "in which case the authorities will "jointly or separately convene the appropriate departments, institutions, and enterprises as well as other concerned parties for a public hearing within 90 days of receiving all requisite documents". After this hearing, MOFCOM or SAIC "will then decide whether to approve or reject the application according to law".

No similar procedure is provided for offshore transactions. In practice, MOFCOM has implemented a 30 working-day 'review period' (commencing from the date a complete filing is submitted) during which it is expected that the reported transaction will not be implemented. SAIC has implemented a 30-calendar-day review period. Filings are generally deemed approved if no objection is raised by MOFCOM or SAIC within their respective review periods, as a matter of practice formal no-action letters are not generally issued.

MOFCOM may also initiate a more detailed second-stage review, by notification to the reporting party before the end of the initial 30 working-day review period. This second stage review may include a formal hearing, apparently within the 90 working-day period provided for the entire review.

### *Consequences of non-compliance*

The M&A Regulations do not specify what penalties may be imposed on a party that fails to make a required filing. Accordingly, the existing merger control regime has been largely ignored by some foreign businesses.

However, foreign businesses often anticipate the need to obtain other approvals from MOFCOM and SAIC relating to matters such as the operation of, or transfers of interests in, FIEs in China, and thus have felt it is advisable to comply with the merger control regime.

The introduction of the Anti-Monopoly Law now provides additional motivation for compliance with the existing merger control regime. The new law also includes a merger control regime, which is likely to replace the existing regime when it commences. However, the enforcement

body for the new regime is likely to be staffed by personnel that include existing Ministry of Commerce officers.

In this context, and noting that the Anti-Monopoly Law provides the enforcement body with power to impose significant fines and other penalties on non-compliant parties, it is suggested that it would be unwise for businesses to disregard the existing merger control regime prior to commencement of the Anti-Monopoly Law.

**How Mayer Brown JSM's Antitrust & Competition Team can assist:**

Mayer Brown JSM's Antitrust & Competition Team is experienced in preparing antitrust filings in China and obtaining regulatory clearances in relation to merger and acquisition activity. Our team has in-depth knowledge on the existing M&A Regulations and the new Anti-Monopoly Law, as well as the multitude of other laws and regulations in China containing anti-trust and foreign investment matters.

## Regional Developments

## Hong Kong: The Competition Policy Advisory Group's 06/07 Annual Report - Key Reviews And Key Take-outs

**Key points:**

The Competition Policy Advisory Group recently released its 06/07 Annual report, which includes an outline of complaints that it has reviewed relating to alleged anti-competitive practices in Hong Kong. Notably, the businesses that were the subject of these complaints include supermarkets, airlines, banks and raw materials suppliers - who are all members of industries that some commentators have identified as likely to come under scrutiny when a general Hong Kong competition law is introduced.

The Hong Kong government's Competition Policy Advisory Group ("**COMPAG**") recently released its annual report for the financial year 1 April 2006 to 31 March 2007. The report includes an outline of alleged anti-competitive practices that COMPAG reviewed during the year.

COMPAG is tasked with reviewing such allegations and, where appropriate, determining whether the Hong Kong government's competition policy has been breached (although COMPAG commonly passes the complaints on to specialist industry bodies for the requisite investigation). Although COMPAG has no power to sanction businesses found to have acted contrary to the policy, it can publish adverse findings.

Interestingly, a number of the complaints reviewed by COMPAG during 06/07 concern industries that are regularly cited as likely targets for review when a general Hong Kong competition law is introduced. The relevant complaints, and their outcomes (where applicable), are summarised below.

***Supermarkets***

The supermarket sector is commonly referenced in commentary regarding the need for a competition law in Hong Kong, as it is dominated by two incumbents (Park'n'Shop and Wellcome) who have been accused of unfairly wielding their market power to stifle price competition and hinder the entry of new market participants.

Supermarkets were the focus of two of the recent complaints reported by COMPAG. One

complaint concerned allegations that a supermarket unilaterally raised the retail price of a supplier's

products above an agreed level, and, after displaying the supplier's products for only a few months, ceased stocking the products upon the launch of similar products under the supermarket's own brand name. The complaint remains under investigation by the Consumer Council, and raises issues of whether market power was abused.

COMPAG also reported allegations made by representatives of the rice industry in Hong Kong concerning 'predatory pricing' behaviour by supermarkets. Predatory pricing involves the temporary lowering of prices by a business with the aim of preventing competitors from being able to effectively establish or sustain a position in the market. Although consumers may benefit from the lower prices in the short term, their interests may be damaged in the long run if monopoly power results.

COMPAG referred the complaint to the then Commerce, Industry and Technology Bureau and the Trade and Industry Department, who determined that the allegations could not be substantiated.

### *Airlines*

COMPAG reported allegations that certain airlines had engaged in predatory pricing by offering air tickets through their own websites at lower prices than they offered to their designated travel agents, and by introducing 'air ticket & hotel' packages with a view to providing greater discounts to customers.

The complaint was reviewed by the Economic Development and Labour Bureau (EDLB), who determined that the complainant had not provided sufficient evidence to prove that the relevant conduct amounted to predatory pricing.

The decision reflects the fact that the mere act of undercutting competition or existing distribution arms will not of itself generally be sufficient to sustain an allegation of predatory pricing conduct. As noted above, it is generally required that there be evidence that the relevant pricing conduct was part of a deliberate strategy to harm competitors.

### *Banks*

The banking sector was the subject of one reported complaint. Specifically, it was alleged by the Hong Kong Association of Online Brokers (HKAOB) that some banks were discriminating against brokers by:

(a) refusing to quote interest rates to brokers on the first day of an IPO;

(b) quoting rates that are higher than those offered to the banks' own retail clients; and

(c) refusing to provide IPO financing to brokers.

The HKAOB considered such conduct to be anti-competitive because it diverted retail clients away from stockbrokers, and distorted the market by driving up interest rates.

The complaint was directed to the Securities and Futures Commission, who (after consultation with the Hong Kong Monetary Authority) concluded that the relevant banking practices did not raise any concerns in the context of the government's competition policy. Accordingly, COMPAG decided that the complaint was unsubstantiated.

### *Bitumen*

COMPAG also reported on a complaint relating to alleged collusion and tender-rigging relating to the supply of bituminous materials.

Specifically, it was reported that an anonymous complainant alleged two suppliers refused to supply bids (or genuine bids) for government road-maintenance projects after two other suppliers had agreed on a fixed price with other bidders. The complaint remains under investigation.

Markets for the supply of raw materials of this nature are commonly the subject of review by competition investigators around the world, as their capital-intensive nature and the difficulty of transporting the materials long distances often leads to localised markets that are dominated by a small number of participants.

Indeed, the market for the supply of asphalt (for which bitumen is one of the major raw materials), was the subject of a review by the Environment, Transport and Works Bureau in 2003 after allegations of anti-competitive cartel practices were raised. However, the bureau did not find any evidence of anti-competitive practices in the asphalt supply market.

***Key Points To Note***

The Consumer Council has cited the various complaints referenced in the latest COMPAG annual report as indicating an "increasing awareness" of competition issues in Hong Kong.

However, the lack of substantiated complaints may also indicate how difficult it can be to prove allegations of anti-competitive practices in the absence of a competition regulator that has strong investigatory and enforcement powers.

The Hong Kong government has indicated that it will seek to address this issue when a new general competition law is introduced. In this context, all businesses in Hong Kong (and especially those in industries that are commonly cited as raising competition concerns) need to ensure they will be in a position to demonstrate compliance with such a law when it is introduced.

## Hong Kong & China - Competition Law Fundamentals

Each issue JSM will consider one element of China and Hong Kong's existing or proposed Competition Laws. This month we examine "Market Allocation"

***What is 'Market Allocation'?***

From a competition law perspective, market allocation is (in essence) an agreement between two or more competing suppliers or competing purchasers to divide the relevant sales or purchasing market in which they are involved, so that one or more of them will have some form of exclusive or priority rights in relation to a particular segment of that market.

As such an arrangement subverts the free workings of the market system, it is commonly prohibited by competition laws around the world, either outright - or where it is deemed to have been arranged in order to cause, or with the result of causing, a threshold level of competition restriction.

Such a prohibition is included in China's new Anti-Monopoly Law, which will commence on 1 August 2008. Under Article 13(iii) of the law, an agreement between competitors to "segment the sales market or the raw materials purchasing market" is a 'monopoly agreement' that is prohibited unless relevant exceptions apply.

In Hong Kong, 'market allocation' is also one of the forms of anti-competitive conduct that the Competition Policy Review Committee has recommended be prohibited by a new general competition law.

***What are the various forms of 'Market Allocation'?***

Market allocation may take many forms. Markets can effectively be divided up by reference to factors such as the type or geographic location of supplier or purchasers with whom relevant market transactions occur, and the type of products that are the subject of such transactions. Alternatively, competitors may agree to allocate dealings with a particular trading partner on the basis of matters such as their supply or purchasing capacity at any particular time or by 'taking turns'. Essentially, there is no limit to the forms of market allocation that may occur.

Whether or note these forms of market allocation:

- are engaged in an ongoing systematic manner, or on ad-hoc (or even a once-off) basis; or
- occur by reference to firm and sophisticated allocation principles, or on a less developed basis,

it is commonly the case that any form of agreement between competitors as to who will supply to, or purchase from, a particular trading partner (whether they are specifically or broadly

identified) will fall within the ambit of the relevant competition law prohibition.

***When is 'Market Allocation' unlawful?***

In some jurisdictions, such as Australia, market allocation agreements are only prohibited if they result in a threshold level of competition restriction or 'lessening' in a relevant market. However, in other jurisdictions, such as in the EC and in Singapore, such conduct is effectively prohibited per se.

China's new Anti-Monopoly Law (which commences 1 August 2008) currently appears to prohibit market allocation per se. However, it is expected that implementation rules and/or guidelines will be issued in relation to the Anti-Monopoly Law in coming months, which will provide additional guidance on certain provisions and prohibitions in the law. It may be that this will include the establishment of a substantive standard for determining when conduct such as market allocation will be unlawful or actionable under the Anti-Monopoly Law.

It is not yet clear how market allocation may be treated in this context under a Hong Kong general competition law.

***Issues and difficulties***

In many cases, it is plainly evident that an agreement constitutes a potentially unlawful market allocation agreement under a relevant competition law. In other instances, this will be less clear.

A classic example of the latter is in relation to exclusive licensing agreements relating to matters such as production technology. Where a supplier licences other parties to use its production technology, but restricts the licensees from selling the end-product in (for example) particular geographic areas which may be particularly profitable for the licensee, the question arises as to whether this should properly be considered anti-competitive market allocation.

Although all of the elements of a typical 'market allocation' offence are present (being an agreement between competitors in a market to divide up that market), it is also clear that there may be less competition in the market but-for the existence of the relevant licence agreement.

In jurisdictions where market allocation is prohibited per se, this issue can be dealt with via 'exceptions' that allow conduct that may otherwise be considered anti-competitive to be authorised if it satisfies certain criteria - such as enhancing efficiency or resulting in a net public benefit. It is notable that there are a number of exceptions of this nature in the Anti-Monopoly Law in China.

It is also worth noting that most competition law regimes include prohibitions against anti-competitive conduct (including market allocation) and merger control provisions. In relevant instances this will prevent businesses from avoiding the prohibition against market allocation (and other forms of 'cartel' conduct) by formally combining their businesses in some manner. In the context of Hong Kong, the Competition Policy Review Committee has recommended that merger control provisions not be included in any new general competition law, and accordingly, the potential 'loophole' may remain open.

**How Mayer Brown JSM's Antitrust & Competition Team can assist:**

Mayer Brown JSM's Antitrust & Competition Team is at the forefront of emerging competition law and antitrust issues in China and Hong Kong. The team is experienced in identifying the issues that anti-competitive conduct prohibitions raise for various forms of business arrangements, and is available to conduct appropriate reviews, and to roll-out tailored training programs, to ensure compliance with competition laws.

## Talk to Us

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