Hong Kong Competition Law Series
ABOUT OUR PRACTICES

Anti-Trust and Competition

Mayer Brown JSM’s Anti-trust and Competition Group is one of the leading providers of legal services relating to local and cross-border competition work in Asia. We have a dedicated team of anti-trust and competition lawyers who are experienced in providing commercially relevant advice relating to rapidly developing antitrust regimes in Hong Kong, China and beyond. We have assisted numerous clients with proactive behavioural counselling and competition law compliance initiatives across the region.

Hong Kong Competition Law Series

This book comprises a number of articles that were issued between March 2015 and July 2015. For details of the currency of the information presented within, please refer to the “As of” date at the foot of each page.
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Foreword

In 2015 we released a series of articles in response to a demand from our clients and the Hong Kong business community to learn more about the impending commencement of Hong Kong’s first cross-sector competition law.

Competition law is a new and complex area of law and, without the benefit of detailed guidance or precedent, many businesses are finding it difficult to assess their risk exposure and achieve compliance with the Ordinance.

We at Mayer Brown JSM understand that an effective risk management strategy is one that forms an integrated and instinctive part of a business, where risk is nipped in the bud and not allowed to develop into problems for the business. A vital part of that strategy is to empower employees to identify potential issues so that they can be efficiently dealt with internally.

With this in mind, we produced a series of 21 short articles, published on a weekly basis throughout the course of March to July 2015, which introduced the common types of conduct to which competition law will apply. The articles are written in a concise, digestible format aimed to facilitate a practical understanding of competition law.

We are pleased to present a compilation of the Hong Kong Competition Law Series. We hope you find this consolidated publication a comprehensive and handy reference guide. For those of you reading this series for the first time, we hope you find the series a useful and fun-to-read introduction to competition law.
Introduction

Since the Competition Ordinance (Cap. 619) (the Ordinance) was passed into law over three years ago in June 2012, the business community in Hong Kong has been preparing for the day the Ordinance will enter into full enforcement.

Full Enforcement on 14 December 2015

In July this year the government appointed 14 December 2015 as the date of commencement of the Ordinance. According to a press release issued by the Competition Commission (the Commission), the Commission is “ready to be an effective enforcer of the competition law which will support Hong Kong’s open economy by ensuring fair and free markets for all”.

Implementation Guidelines

Hot on the heels of that announcement, the Commission published six implementation guidelines jointly with the Communications Authority, which address the Conduct Rules, Merger Rule and other procedural matters including complaints, investigations and block exemption applications. Although the implementation guidelines will not be binding on the Commission, they contain numerous illustrative examples and serve as a good indication of how the Commission intends to interpret the Ordinance.

Subsidiary Legislation

The government has also issued a number of subsidiary regulations in relation to statutory bodies, exempted persons and calculation of turnover.

Statutory Bodies and Exempted Persons

STATUTORY BODIES TO WHICH ORDINANCE WILL APPLY:
1. Ocean Park Corporation
2. Matilda and War Memorial Hospital
3. Kadoorie Farm and Botanic Garden Corporation
4. The Helena May
5. Federation of Hong Kong Industries
6. The general committee of the Federation of Hong Kong Industries

The other 575 statutory bodies in Hong Kong will be exempt from the First Conduct Rule, the Second Conduct Rule and the Merger Rule (collectively, the Competition Rules) and the enforcement powers of the Commission and Competition Tribunal (Tribunal). Although exempt, these statutory bodies will still be required to adhere to the principles underlying the Competition Rules and to offer assistance in investigations by the Commission (Part 3) as well as proceedings or appeals before the Tribunal (Parts 5, 7 and 10).

**SPECIFIED PERSONS TO WHICH ORDINANCE WILL BE DISAPPLIED:**

1. The Stock Exchange of Hong Kong Limited
2. Hong Kong Futures Exchange Limited
3. Hong Kong Securities Clearing Company Limited
4. HKFE Clearing Corporation Limited
5. The SEHK Options Clearing House Limited
6. OTC Clearing Hong Kong Limited
7. Hong Kong Exchanges and Clearing Limited

**Calculation of Turnover**

The Competition (Turnover) Regulation (Turnover Regulation) sets out rules for calculating turnover, which are relevant to the following determinations:

1. Whether an undertaking can avail itself of the exclusion for agreements or conduct of lesser significance (SME Exclusion); and
2. The amount of fines payable by an undertaking upon having contravened a Competition Rule.

<table>
<thead>
<tr>
<th>AMOUNT</th>
<th>SME EXCLUSION</th>
<th>FINE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total gross revenues derived from ordinary activities both in Hong Kong and outside of Hong Kong;</td>
<td>Total gross revenues derived from ordinary activities in Hong Kong only;</td>
<td></td>
</tr>
<tr>
<td>- sales rebates;</td>
<td>- sales rebates;</td>
<td></td>
</tr>
<tr>
<td>- taxes directly related to the revenues;</td>
<td>- taxes directly related to the revenues;</td>
<td></td>
</tr>
<tr>
<td>+ grants, subsidies or financial assistance received in return for a contractual obligation to supply goods or services to a third party.</td>
<td>+ grants, subsidies or financial assistance received in return for a contractual obligation to supply goods or services to a third party.</td>
<td></td>
</tr>
</tbody>
</table>

**RELEVANT UNDERTAKINGS**

Includes revenues generated by all affiliates of the undertaking, less intra-group transactions.

**RELEVANT PERIOD**

The last calendar year or the financial year ending in the last calendar year. Each year in which the contravention occurred, or, if the contravention occurred in more than 3 years, the 3 years with the highest turnover.

**SME Exclusion**

As noted above, the Turnover Regulation is relevant in assisting undertakings to determine whether they benefit from the SME Exclusion.

The First Conduct Rule will not apply to agreements between undertakings with a combined turnover not exceeding HK$200 million in the preceding financial year. However, the exclusion will not apply to the four types of “serious anti-competitive” or “hardcore” conduct regardless of the combined turnover of the undertakings to the agreement. The Second Conduct Rule will not apply to undertakings with a turnover not exceeding HK$40 million in the preceding financial year.

The aim of the SME Exclusion is to reduce the compliance burden and costs for SMEs, however, it is not as broad as the de minimis arrangements available in some other competition law jurisdictions.

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2. Pursuant to section 93(3) of the Ordinance, an undertaking may be fine up to 10% of its total gross revenues in Hong Kong for each year in which a contravention occurred.
Leniency Policy and Enforcement Priorities

In the pipeline, to be expected before the commencement date of 14 December 2015, are the Commission’s leniency policy for cartel conduct and a statement of the Commission’s enforcement priorities.

The Commission’s statement of enforcement priorities is an important document which will, short of identifying specific sectors or businesses, give businesses an idea of where the Commission intends to focus its enforcement activity and what considerations may drive the Commission’s decision to commence an investigation or market study.

1. Competition Starts Now

Prevention is Better than Cure

Hong Kong’s first cross sector competition law is set to enter into full operation on 14 December this year. The impending commencement of Hong Kong’s first cross-sector competition law brings to Hong Kong businesses a fresh challenge of managing competition law risk.

As of 14 September 2015

As the saying goes, “prevention is better than cure”. Business performance is all about improving competitiveness in an evolving market. As competition lies at the core of business strategy, competition law risk management will inevitably become an element of success. The more you are alive to competition law considerations at the very inception of business strategy, the better you will be able to avoid the pitfalls and compete efficiently and intelligently at the outset.

Effective compliance generates value. Not only does it help you stay ahead of your competitors, it can also earn you a stellar reputation in the eyes of consumers and save you millions in avoidable legal cost. Knowing your rights can also protect your business from unfair competition, for example, if your competitors gang up on you.

Fear Not, We Get It

Mayer Brown JSM understands the prospect of a new law that can be enforced against almost all business conduct can be daunting, especially as
the types of conduct that potentially give rise to competition law risk are myriad.

To help businesses navigate the minefield of competition law and to cultivate a culture of compliance, Mayer Brown JSM has published a series of articles, compiled in this booklet, on the types of conduct to which the Conduct Rules\(^3\) will apply. Hopefully by the time the law comes into force, you will become something of an expert on competition law!

**The Golden Rules**

Before we delve into the specifics of competition law, we set out below fundamental “Golden Rules”, which are a basic but useful gauge of whether your intended conduct may entail competition law risk:

- Businesses should compete independently.
- Collaboration among independent businesses may be pro-competitive if there is good commercial justification (usually this means consumer benefit, as well as efficiency gains or innovation):
  - Lower prices
  - Increased choice
  - Improved product and/or service quality
  - Drives innovation
  - Benefits consumers
- Market power should not be used to exploit business partners or customers.
- In the next article, we kick off our Hong Kong Competition Law Series with an overview of the Cardinal Sins, i.e., the four most serious types of anti-competitive conduct under the new Competition Ordinance (Cap. 619).

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\(^3\) The First Conduct Rule prohibits undertakings from making or giving effect to agreements or decisions or engaging in concerted practices that have as their object or effect the prevention, restriction or distortion of competition in Hong Kong; the Second Conduct Rule prohibits undertakings that have a substantial degree of market power in a market from engaging in conduct that has as its object or effect the prevention, restriction or distortion of competition in Hong Kong.
2. The Cardinal Sins

This article kicks off our discussion on the types of conduct that may infringe the Competition Ordinance with the Cardinal Sins: the four most serious types of anti-competitive conduct that will almost always contravene competition law.

First Cardinal Sin: Price Fixing

Price fixing is where two or more competitors agree (whether formally or informally, directly or indirectly, or by a nod and a wink) to set prices (including any component or formulae of price), for the sale of goods or services.

Second Cardinal Sin: Output Limitation

Output limitation is where competitors agree to limit the volume or type of goods or services they supply.

As of 18 - 24 March 2015
Third Cardinal Sin: Market Sharing

Market sharing is where competitors carve up a market, whether by the type of goods or services they sell, or by the type or location of customers they serve, and agree not to “overstep” into each others’ territory.

Fourth Cardinal Sin: Bid Rigging

Bid rigging is where, after having agreed among themselves who the winner should be, competitors participate in a bid for the sake of appearance and use tactics to engineer that result.

Each of the Cardinal Sins entails an “agreement” between competitors. In the next article, we explore the concept of an “agreement” and start to take a deeper look at the various forms each Cardinal Sin may take.

3. Cardinal Sin No. 1 – Price Fixing

In the last article we gave you an overview of the four Cardinal Sins under the Competition Ordinance. This week we discuss Cardinal Sin No.1 – price fixing.

Price fixing is one of the worst violations of competition law that will attract the most serious fines. While price fixing may sound straightforward and intuitive, in practice, the legal concept of price fixing captures a wide array of conduct, some of which you may find yourself inadvertently engaging in.

In this article we examine the elements of price fixing and use examples to illustrate how you may avoid entering into a price fixing agreement.

Price Fixing

Price fixing refers to an agreement between competitors to fix, maintain, increase or otherwise control prices.

Why Fix Prices?

Price fixing inflates prices and therefore profits by preventing competitors from undercutting each other on price.

What is an Agreement?

A mere “meeting of minds” suffices to bring anti-competitive conduct within the scope of the First Conduct Rule. Anti-competitive agreements do not have to be, and indeed, are most often not, set in stone.
To illustrate, an agreement may arise from any form of understanding, including:

<table>
<thead>
<tr>
<th>WHAT?</th>
<th>WRITTEN</th>
<th>ORAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A contract; an email.</td>
<td>A phone call.</td>
</tr>
<tr>
<td>WHERE?</td>
<td>FORMAL</td>
<td>INFORMAL</td>
</tr>
<tr>
<td></td>
<td>An association meeting.</td>
<td>A chat at a bar; scribbles on a napkin.</td>
</tr>
<tr>
<td>WHO?</td>
<td>INDIVIDUAL</td>
<td>ASSOCIATION</td>
</tr>
<tr>
<td></td>
<td>Between competitors.</td>
<td>Among members of a trade association.</td>
</tr>
<tr>
<td>HOW?</td>
<td>DIRECT</td>
<td>INDIRECT</td>
</tr>
<tr>
<td></td>
<td>Between the parties to the agreement.</td>
<td>Through an intermediary.</td>
</tr>
<tr>
<td></td>
<td>OVERT</td>
<td>COVERT</td>
</tr>
<tr>
<td></td>
<td>An open exchange.</td>
<td>A discreet wink and nod; a signal; an exchange of future pricing intentions.</td>
</tr>
</tbody>
</table>

What is Price?
The concept of price in a competition law context encompasses all components of price. This may include any discount, rebate, allowance, price concession or other advantage in relation to the supply of goods or services: An agreement to fix any of the above components could constitute price fixing.

How are Prices Fixed?
As mentioned above the concept of price fixing includes any form of controlling prices, such as maintaining or increasing prices. Below are some examples of conduct that can amount to “fixing”:

- Agreeing to a fee schedule.
- Capping the level of discount.
- Publishing “recommended” fee schedules which competitors then follow.

In the next article, we will take a look at Cardinal Sin No. 2 – output limitation.

4. Cardinal Sin No. 2 – Output Limitation

In this article we discuss Cardinal Sin No. 2 – output limitation.

Output Limitation

Output limitation refers to agreements between competitors to fix, maintain, control, prevent, limit or eliminate the production or supply of products.

WHY LIMIT OUTPUT?
To create a scarcity of supply to increase prices and therefore maximise the profit margin.

WHAT IS OUTPUT?
Output limitation can occur at any level of the production or supply chain. The following are some examples of “output”:

- Raw materials;
- Essential facilities;
- Spare parts;
- Products or services; and
- Future products or services.

WHAT DOES “LIMITATION” MEAN?
While businesses can independently determine their individual levels of output, they cannot agree with competitors to fix, maintain, control, prevent, limit or eliminate output. This is the case even in times of economic recession or crisis.
Consider this example of output limitation:

Due to the proliferation of competitive technology start-ups, incumbent manufacturers of smart phones have been losing market share and the price of smart phones have dropped significantly.

To counter this, the major manufacturers of smart phones enter into a “one per year” agreement, where they commit to limit the number of smart phones they introduce into market to no more than one per year.

Even though the agreement concerns future smart phones which may not have been manufactured or even designed, the manufacturers have already limited their output to one per year, for the purpose of dampening increasingly intense competition.

Without the “one per year” agreement, smart phone producers would all have to “out-innovate” and “out-price” each other to stay ahead of the competition – the pace of introducing new smart phones into the market would be determined by the speed of innovation, research and development and market demand. The “one per year” agreement is a blatant example of output limitation which limits competition in the smart phone market and harms consumers.

In the next article we will take a look at Cardinal Sin No.3, market sharing.

5. Cardinal Sin No. 3 – Market Sharing

In the last article we looked at the Cardinal Sin of output limitation. In this article we discuss Cardinal Sin No. 3 – market sharing.

Market Sharing

Market sharing refers to agreements between competitors that allocate sales, territories, customers or markets for the production or supply of goods or services.

WHY MARKET SHARE?

To insulate businesses from competition in their agreed “slice of the market” and, in doing so, maintain profitability and market share.

WHAT IS A MARKET?

A market may be a sales territory, a market for goods, or customers. There may be a number of ways to carve up a market; here are some examples:

- **PRODUCT**
  - By type
  - By value

- **CUSTOMER**
  - By locale
  - By income

- **GEOGRAPHY**
  - By point of sale
  - By mode of sale (on- or offline)
WHAT DOES SHARING MEAN?

Sharing essentially means competitors agree not to encroach upon each other’s assigned or allocated slice of the market.

It could also include an agreement to maintain the status quo with respect to each others’ market shares, such as by agreeing:

- Not to transact with each others’ customers;
- To encourage customers to stay with their existing supplier or seller; or
- To compensate each other for any customer-driven changes in market share.

In the next article we will take a look at Cardinal Sin No.4, bid rigging.

6. Cardinal Sin No. 4 – Bid Rigging

In the last article we looked at the Cardinal Sin of market sharing. In this article we discuss Cardinal Sin No. 4 – bid rigging.

Bid Rigging

Bid rigging refers to agreements between competitors not to compete for a tender, and instead allowing a designated winner to be awarded the project or contract.

WHY RIG BIDS?

To prevent competitors from undercutting each other, and enable each competitor to charge a higher price or lower the quality of goods or services offered.

WHAT DOES BID RIGGING ENTAIL?

A “rigged” tender or bid is one that has a predetermined result engineered by the competing participants in the tender, i.e., there is one “chosen winner” and others agree to be “designated losers”. Below are some examples of how bids are commonly rigged:

- **Sham bidding:** the designated losers submit bids that are bound to be rejected:
  - Cover bidding: the designated losers submit bids that are less attractive due to higher prices or lower quality.
  - Non-conforming bids: the designated losers submit bids that do not conform to the tender specifications.

- **Bid rotation:** competitors take turns being the chosen winner.
Bid suppression or withdrawal: the designated losers either refrain from bidding, or withdraw their bid to allow the chosen winner to win.

WHAT DO THE “DESIGNATED LOSERS” GET OUT OF IT?
Participants in a bid rigging agreement benefit in the following ways:

• Bid rigging may be part of a market sharing agreement, where competitors maintain their allocated share of the market by refraining from participating in tenders, or by always submitting sham bids in each others’ share of the market.
• The chosen winner compensates the designated losers by letting them win another tender or appointing them as a subcontractor.
• The chosen winner pays the designated losers a fee.

This concludes our discussion of the Cardinal Sins: price fixing, output limitation, market sharing and bid rigging. Remember, these are the most harmful forms of anti-competitive conduct that will almost always fall foul of the First Conduct Rule.

In the next article we look at information exchange among competitors, a complex but intriguing area of competition law.

7. Information Exchange

Don’t Let The Cat Out Of The Bag

Information exchange is an area of competition law that is rife with risk. There are few bright line rules on what can and cannot be exchanged, the scope of the prohibition is potentially extremely broad, and the risk of inadvertent breach is high as anti-competitive information exchange may occur spontaneously in informal settings such as social gatherings or trade association meetings.

Figuring out what you can and cannot say to a competitor is not a straight-forward task, but it is an important one.

Once you let the cat out of the bag, there’s no going back.

WHY IS INFORMATION EXCHANGE AN ISSUE?

Information is power. Communications between businesses take place on a daily basis and are more often than not legitimate. Competitor intelligence enables more informed competition and business practice, improves market sensitivity and facilitates industry benchmarking and self-regulation.

But with power comes responsibility, and businesses cannot always be entrusted with commercially sensitive information. The disclosure, exchange or use of commercially sensitive information in and of itself could in some circumstances be unlawful, especially when it enables competitors to become aware of their competitors’ market strategy. The sharing of commercially sensitive information artificially reduces competitive uncertainty in the market, potentially enabling competitors to align their conduct to maximise profits jointly rather than focusing on lowering prices and improving the quality of goods and services to win customers.
Information exchange is particularly risky where competitors gather under the auspices of an industry or professional association, on occasions such as committee meetings, working groups, conferences and briefings, where the concentration of competitors in the room means a single disclosure of competitively sensitive information could be particularly damaging.

**WHAT CAN YOU SAY AND NOT SAY?**

Whether information can be legitimately exchanged depends very much on the context of the disclosure/exchange and what the parties intend to do with it. Generally, if the information is not publicly available, and its receipt may influence the recipient’s conduct on the market, disclosing it to a competitor may be problematic.

The following chart sets out roughly where the risk areas are. It is not to be taken as a substitute for case by case analysis, but it provides an idea of when you may need to take a step back and consult your legal advisors before proceeding with a conversation.

<table>
<thead>
<tr>
<th>GRANULARITY</th>
<th>HIGH RISK</th>
<th>MEDIUM RISK</th>
<th>LOW RISK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individualised,</td>
<td>Individualised</td>
<td>Individualised</td>
<td>Aggregated, general</td>
</tr>
<tr>
<td>specific</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SOURCE</td>
<td>Private, confidential*</td>
<td>Public</td>
<td>Private</td>
</tr>
<tr>
<td>TYPE</td>
<td>Pricing, output, strategy</td>
<td>Cost, terms, R&amp;D, marketing, capacity</td>
<td>Regulatory, safety, security, broader trends</td>
</tr>
<tr>
<td>AGE</td>
<td>Future</td>
<td>Future</td>
<td>Current, recent</td>
</tr>
<tr>
<td>FORUM</td>
<td>Private</td>
<td>Private/Public</td>
<td>Private/Public</td>
</tr>
<tr>
<td>MODE</td>
<td>Direct</td>
<td>Direct/Indirect</td>
<td>Direct/Indirect</td>
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</tbody>
</table>

Generally, the more frequent and regular the exchanges of information, the greater the likelihood of anti-competitive harm. That being said, in some circumstances, even one isolated exchange of competitively sensitive information can give rise to a concerted practice.

4 Additionally, disclosing private information may be a breach of your confidentiality obligations.

**WHAT IF A COMPETITOR DISCLOSES UNSOLICITED SENSITIVE INFORMATION TO YOU?**

The mere receipt of commercially sensitive information could be sufficient to implicate you if you fail to immediately object to the disclosure of that information! The burden is on the recipient to prove that it did not use the information received, and this can be a challenging burden to satisfy. If in doubt, do not simply sit on the information received; contact your legal advisors immediately for assistance to formulate a plan of action.

In the next article, we introduce group boycotts, a type of anti-competitive conduct competition authorities typically regard as a serious violation of competition law.
8. Collective Boycott

Don’t Gang Up!

A collective boycott, or a collective refusal to deal, occurs where two or more businesses collectively refuse to deal with a third party. While businesses are free to choose their business partners, ganging up to exclude an actual or potential competitor can be considered anti-competitive.

WHY BOYCOTT?

A boycott is an effective way of inflicting targeted harm on other players in a relevant market. There can be various reasons for effecting a boycott, including (1) to prevent market entry or to drive a player out of the market, (2) to enforce the terms of a cartel against a ‘rogue’ member (e.g., to punish discounting in violation of a price fixing arrangement), or (3) to prevent or delay innovation or new business models.

WHO IS USUALLY INVOLVED?

Collective boycotts may have a horizontal or vertical aspect, or both, or it may be driven by a trade association or consortium of businesses. Examples of the different forms a collective boycott can take include: (1) refusal of a trade or industry association to admit a new member; (2) an agreement among suppliers that impact customers; (3) an agreement among customers that impact a supplier; or (4) an agreement between competitor and a common supplier, or suppliers, to deny you access to an important resource or facility.

HOW DOES A BOYCOTT WORK?

Any form of conduct that involves ganging up to exclude an actual or potential competitor from the market without objective business justification may amount to a boycott, for example:

• Terminating business relationships with a third party in a coordinated manner;
• Setting exclusionary membership requirements to prevent a competitor from joining as a member; or
• Refusing to supply an important resource or facility, or only supplying it on unreasonable terms.

IS A BOYCOTT EVER JUSTIFIABLE?

A collective boycott may, depending on the circumstances, be justifiable on the following grounds:

• Efficiency considerations such as establishing more efficient distribution channels, reducing costly supply arrangements or lowering product costs;
• Protecting the safety and security of a system or network; or
• Protecting incentives to invest and innovate.

In the next article we will look at Resale Price Maintenance (RPM), a type of agreement commonly entered into between businesses operating at different levels of a relevant market.

5 An important resource or facility is one which cannot be replaced at a comparable cost, e.g., essential raw materials, supplies, key distribution channels, infrastructure etc.
9. Resale Price Maintenance

Resale Price Maintenance (RPM) is a type of vertical price restriction where an upstream supplier requires an independent reseller to resell at a fixed or minimum resale price. RPM is called a “vertical” agreement because it is an agreement between businesses operating at different levels of the supply chain.

An RPM is typically enforced by one or more of the following mechanisms:

- The supplier punishes non-compliant resellers by threatening to stop supplying the product; or
- The supplier provides incentives for observing the fixed resale price.

WHY MAINTAIN RESALE PRICES?

Suppliers may impose RPM as part of a wholesale price-fixing arrangement. Setting the resale price reduces incentives for individual resellers to undercut each other to gain market share at the distribution/retail level, and facilitates enforcement of a cartel.

RPM may also originate from resellers who may wish to use RPM to disguise/enforce a price fixing arrangement.

On the other hand, there may be business justifications for implementing RPM within a single-brand distribution or retail network, such as:

- To promote consumer interest in a new product;
- To encourage retailers to invest in customer service and enhance the retail experience, thereby increasing the competitiveness of the brand compared to other brands;
- To improve after-sales and maintenance services;
- To prevent discount or non-prestige distributors or retailers from free-riding on the benefits of investment made by the supplier or other distributors or retailers of the same brand; and
- To strengthen inter-brand competition in a franchise system.

As the nature of these justifications suggests, RPM is usually more likely to give rise to efficiencies where the distribution or sale of the product requires product-specific investment, e.g., at the inception of a new product, within a franchised distribution network, or in relation to luxury or complex products.

WHAT ARE THE HARMS OF RPM?

RPM may restrict competition in the following ways:

**AT THE SUPPLIER LEVEL...**

- A broad RPM arrangement may increase price transparency in the market and facilitate coordination between competing suppliers.
- Where RPM is implemented by a supplier with market power to protect the profit margin of resellers, smaller suppliers may be excluded from the market by reason that the resellers do not have incentive to deal with other suppliers outside of the RPM arrangement.

**AT THE DISTRIBUTOR/RETAILER LEVEL...**

- RPM restricts the ability of resellers to compete on price.
- RPM may restrict market entry at the distributor/retail level and hinder the emergence of innovative distribution/retail business models.
- RPM may be requested by resellers to facilitate coordination in pricing.

Competition law treatment of RPM has traditionally been strict. Recently however, competition authorities and courts in many mature competition law jurisdictions are increasingly receptive to efficiency justifications for RPM. Ultimately whether an RPM arrangement is justifiable will depend on the context of the restriction and must be analysed on a case by case basis.

WHAT ABOUT RECOMMENDED PRICES OR MAXIMUM PRICES?

It may be permissible to give non-binding price recommendations, or suggest a maximum resale price, but problems may arise when:

a. Despite not being mandatory, the recommended or maximum prices serve as a “focal point” for reseller pricing; or
b. The supplier enforces recommended or maximum prices as if they are a fixed or minimum retail price.

The risk of anticompetitive effects arising from a vertical pricing restriction increases with market power. In determining whether a restriction is anti-competitive, it would be necessary to examine the actual and potential effects of the restriction on the relevant market.

In the next few articles, we will look at different forms of distribution agreements, starting the discussion with exclusive distribution, followed by selective distribution and franchise arrangements.

10. Exclusive Arrangements

WHAT ARE EXCLUSIVE ARRANGEMENTS?

Exclusive arrangements are a type of vertical arrangement, whereby one party imposes restrictions on the other’s ability to choose with whom, in what or where it deals. It is a common business practice and can take many forms. Often, it requires a buyer (whether a reseller or end-user) to deal exclusively with a seller. In most cases it will not harm competition.

For example, a manufacturer may agree to supply a distributor provided it agrees not to carry the products of the manufacturer’s competitors. It can also occur between sellers and consumers such as when consumer agrees to purchase all its requirements of a particular product from a single supplier. It can also involve a seller dealing exclusively with a single buyer.

Both the First Conduct Rule and Second Conduct Rule can apply to exclusive arrangements. The Second Conduct Rule is only triggered where one of the parties to the exclusive arrangement has market power.

WHY DEAL EXCLUSIVELY?

Exclusivity may be used by a manufacturer with market power to prevent smaller competitors from succeeding in the market place. For example, by denying a competitor access to retailers without which it cannot make sufficient sales to compete effectively. It can also be used by manufacturers to reduce competition between them. For instance, where exclusive supply contracts between manufacturers and their customers operate like a customer allocation agreement so that the two manufacturers do not need to compete for each other’s customers.
WHAT HARM ARISES FROM EXCLUSIVE ARRANGEMENTS?
The main concern with exclusivity is a market “foreclosure” effect. Foreclosure concerns arise because exclusive arrangements by their nature “tie up” certain distributors or suppliers in a manner that precludes other competitors in the market from dealing with those parties. This raises barriers to entry which makes it easier for existing firms to exploit whatever power they have but difficult for existing competitors to compete effectively or potential competitors to entering a market.

The risk of foreclosure is likely heightened where:
1. **Size of the party:** One of the parties has market power, which increases the likelihood a larger share of the market will be foreclosed;
2. **Network effect:** A large part of the market is tied up in other exclusive arrangements (creating a “network effect” of exclusivity arrangements); and
3. **Duration of exclusivity:** The duration of exclusivity is unjustifiably long.

IT’S NOT ALL BAD NEWS
Notwithstanding the above, an exclusivity arrangement can also be pro-competitive and beneficial, for example if it:

• Encourages a distributor to promote and market the manufacturer’s brand more vigorously and to offer extra services such as fast warranty service or after-sales services;
• Provides retailers with assured supplies which can allow for longer-term planning and investment;
• Encourages manufacturers to help dealers by providing services or information benefitting consumers; and
• Provides a manufacturer with a reliable and steady outlet of supply enabling it to make investments to increase efficiency.

Whether an exclusive arrangement is likely to be justifiable on efficiency grounds requires careful consideration and must be analysed on a case by case analysis.

In the next article, we will take a look at selective distribution agreements.

11. Selective Distribution

WHAT IS SELECTIVE DISTRIBUTION?
Selective distribution is a type of distribution agreement where a supplier sells goods or services to a limited number of “authorised distributors” who are selected on the basis of a set of criteria.

WHY DISTRIBUTE SELECTIVELY?
Selective distribution is an effective way for a supplier to monitor and control the resale process.

As a retail strategy, selective distribution is not uncommon in the sale of goods, e.g. high-tech or complex goods, which warrant technical expertise and responsible selling, or luxury goods where quality customer service and the retail experience is integral to brand integrity.

WHAT HARM COULD ARISE FROM SELECTIVE DISTRIBUTION ARRANGEMENTS?
According to the draft implementation guidelines published by the Hong Kong Competition Commission, selective distribution arrangements are often economically beneficial and an effective way of furthering inter-brand competition.
The potential benefits of selective distribution include:

- Enabling a supplier to build and maintain the image and reputation of a luxury brand;
- Incentivising retailers to increase marketing efforts;
- Encouraging retailers to invest in staff training and improve customer service; and
- Setting and maintaining quality standards.

Where the supplier and/or authorised retailer(s) have market power, however, there is a risk selective distribution may exclude the entry of more efficient or “discount” retailers. In oligopolistic markets, the prevalence of selective distribution networks may facilitate collusion among suppliers.

**WHAT SELECTION CRITERIA ARE ACCEPTABLE?**

Generally, *qualitative and objective* criteria that are fairly and uniformly applied will not be viewed as anti-competitive.

Quantitative criteria such as a fixed number of retailers by locality, the carrying of minimum stock or achievement of minimum turnover may not be problematic, but a review of the selective framework would be advisable to rule out any potentially negative effect on competition.

In the next article, we will take a look at franchise agreements.

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**12. Franchise Agreements**

Franchising is a distribution model where the franchisor grants a bundle of rights to an independent business (the franchisee), allowing the franchisee to trade in the name of the franchisor and adopt the franchisor’s business model.

![Franchise Network Diagram]

**Why Franchise?**

The franchisor achieves scalability for a successful business model and offloads investment and operational risk to the franchisee.

The franchisee gains quick market entry through acquiring the right to adopt a proven business model and operate under an established brand name, and the benefit of transfer of intellectual property rights and know-how.

**WHAT ARE THE POTENTIAL EFFECTS ON COMPETITION?**

To protect the common identity and reputation of the franchised network of businesses, a franchisor will usually:

- Exercise quality control over the franchisee’s business and trading methods, such as, the décor and layout of sales outlets, production process etc.
- Impose an obligation to use the franchisor’s know-how, trade marks, trade names and other industrial property rights, but only to do so as agreed.
• Impose an obligation to sell only to end-users or other franchisees.
• Impose a non-compete obligation for the duration of the franchise agreement.

Whilst it is permissible for a franchisor to exercise control over the franchisee business, it is important to bear in mind that restrictions imposed on the franchisee should not go beyond what is necessary and proportionate to the aims of protecting brand unity, know-how and licensed intellectual property rights.

The following restrictions, for example, may have anti-competitive effects not justifiable by the franchise network:

• Fixing minimum resale prices (as opposed to recommending them).
• Imposing a post-agreement non-compete that is excessive in duration or scope.
• Prohibiting franchisees from selling to, or buying from, other franchisees.

In the next article we will take a look at joint venture agreements.

13. Joint Ventures

An Overview

Joint venture (JV) is a general commercial term that encompasses a range of collaborative activity between businesses, often competitors. JVs may be formal or informal, short- or long-term, and may involve two or more co-venturers.

Full-Function or Non-Full-Function

In competition law, JVs fall into two broad categories to which different rules apply:

<table>
<thead>
<tr>
<th>Full-Function JVs</th>
<th>Non-Full-Function JVs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>WHAT IS IT?</strong></td>
<td>The JV performs, on a lasting basis, all the functions of an independent economic entity.</td>
</tr>
<tr>
<td><strong>WHICH RULE APPLIES?</strong></td>
<td>The Merger Rule: As the formation of a full-function JV brings about a lasting change in the control of the businesses involved, and alters the market structure, the merger rule may apply. In Hong Kong, only the telecommunications sector is subject to the merger rule at the outset.</td>
</tr>
<tr>
<td><strong>WHAT ARE THE DISTINGUISHING FACTORS?</strong></td>
<td>The following factors provide an indication of whether or not a JV is full-function:</td>
</tr>
<tr>
<td></td>
<td>• Whether the JV has a management dedicated to its day-to-day operations.</td>
</tr>
<tr>
<td></td>
<td>• Whether the JV has access to resources enabling it to conduct business activities on a lasting basis.</td>
</tr>
<tr>
<td></td>
<td>• Whether the JV takes over a specific, limited function.</td>
</tr>
<tr>
<td></td>
<td>• Whether the JV has significant dealings with its parents.</td>
</tr>
<tr>
<td></td>
<td>• Whether the JV is created for a meaningful period of time.</td>
</tr>
<tr>
<td></td>
<td>A JV may or may not take the form of a separate legal entity. Whether a JV is full-function or non-full-function is a matter of substance having regard to all relevant circumstances including the above factors.</td>
</tr>
<tr>
<td></td>
<td>Joint production arrangements, joint buying arrangements, joint selling, distribution and marketing arrangements, and joint R&amp;D ventures are usually non-full-function JVs.</td>
</tr>
</tbody>
</table>
FULL-FUNCTION JVs
The formation of a genuine full-function JV, in any sector other than the telecommunications sector, will not be subject to regulation in Hong Kong. After it has been established, however, the JV and its parent companies will each be subject to the conduct rules.

NON-FULL-FUNCTION JVs AND HORIZONTAL COOPERATION AGREEMENTS
Horizontal cooperation agreements merit special treatment under competition law because, although they have the potential to restrict competition, especially where the agreement involves setting prices or the level of output, sharing markets, exchanging information and consolidating market power etc., they are more often than not pro-competitive by object and nature.

Unless a horizontal cooperation agreement contains seriously anti-competitive restrictions, such as the Cardinal Sins, it will likely be permissible under competition law as long as it is appropriately and carefully managed.

Before entering into a horizontal cooperation agreement, parties should satisfy themselves of the following:

• The agreement is for a legitimate, pro-competitive purpose and generates economic efficiencies.
• Arrangements are properly structured in a manner least restrictive of competition.
• Effective compliance safeguards are in place to prevent or minimise any harmful effect on competition that may arise from the implementation and operation of the cooperation agreement.

In the next article we will take a closer look at several common forms of horizontal cooperation.

14. Horizontal Cooperation Agreements
Collaborative agreements between businesses are often commercially attractive and can generate significant economic benefit through combining complementary activities, skills or assets. Businesses may save costs, increase investment and pool know-how; consumers benefit from enhanced product quality, variety and innovation.

WHEN ARE COOPERATION AGREEMENTS “HORIZONTAL”? Agreements between businesses that are actual or potential competitors are “horizontal” cooperation agreements. Businesses active on the same market are actual competitors, and a business is a potential competitor of another business if, despite not being active on the same market, the business can realistically enter the market within a short period of time.

On the other hand, horizontal cooperation may, under certain circumstances, especially where one of the parties has market power, lead to competition problems.

WHAT ARE THE USUAL TYPES OF HORIZONTAL COOPERATION AGREEMENTS? The following are some of the more common types of horizontal cooperation agreements:

<table>
<thead>
<tr>
<th>TYPE</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRODUCTION</td>
<td>Production is carried out by one, two, or more parties, or through a jointly controlled separate legal entity.</td>
</tr>
<tr>
<td>BIDDING</td>
<td>Businesses submit a bid in their joint names, engaging in open, rather than covert, cooperation.</td>
</tr>
<tr>
<td>COMMERCIALISATION</td>
<td>Sales-related collaboration, such as selling, distribution and marketing.</td>
</tr>
</tbody>
</table>

7 The length of time required to enter the market will depend on the legal and economic context of the agreement, the characteristics of the relevant market and whether the potential competitor is a party to the agreement, or a third party. In the European Union, two to three years may be taken as a ballpark for a short period of time.

8 Production JVs include specialisation agreements where one party produces and the other purchases from that party, or each party specialises in the production of different goods and purchase from each other.
Businesses may outsource or jointly engage in R&D work. The scope of cooperation may extend to joint production or commercialisation of the fruits of R&D collaboration.

Joint purchasing or buying arrangements consolidate buyer power which allows the cooperating businesses to drive a better bargain than they would otherwise have been able to.

Uniform technical, quality or safety requirements are agreed and set for complex products or services.

**WHAT ARE THE POTENTIAL HARMs OF HORIZONTAL COOPERATION?**

Depending on the market power of the parties, the market structure, the type of agreement and extent of cooperation between the parties to the agreement, horizontal cooperation may raise the following competition law concerns:

*The risk of collusion*

- The disclosure of strategic information may undermine the parties’ decision-making independence.
- The parties’ cooperation may lead to a significant commonality of costs, in turn affecting prices and output.
- Exchanges of commercially sensitive information may spill over to areas outside the scope of cooperation.

*The risk of reduced competition*

- Unrelated competitors may suffer a significant disadvantage to the cooperating businesses and new entry may be foreclosed by the increased strength of incumbent market power.
- The incentives of one business to expand or enter the market of the other may be reduced.
- Competitive constraint to the cooperating parties may decrease, resulting in higher prices, reduced product variety and choice.

Generally, cooperation objectively necessary for businesses (often SMEs) to launch a product or service will not be anti-competitive.

Even where horizontal cooperation may have the effect of harming competition, it may not be prohibited by competition law if the parties are able to demonstrate that they generate sufficient benefit to justify the harmful effects of their cooperation.

**CAN YOU DO IT?**

Whether a horizontal cooperation agreement may be entered into and how it can be implemented will often depend on what the parties want to do, its potential effects on competition and how the agreement is structured to manage those effects. As horizontal cooperation agreements vary significantly in aim, scope and complexity, there is no one size fits all solution and agreements should be analysed on a case by case basis.

The potential competition law risks of horizontal cooperation can often be managed by putting in appropriate and effective safeguards. When in doubt it may be advisable to seek legal advice at the earliest opportunity to ensure the envisaged cooperation is compliant from the outset.

This concludes our discussion on the First Conduct Rule. In the next article we will take a look at abuse of substantial market power, i.e., the Second Conduct Rule.
Second Conduct Rule
15. Abuse of Substantial Market Power

WITH POWER, COMES RESPONSIBILITY

Being big is not bad, but businesses with substantial market power have a special responsibility not to abuse their position to restrict or eliminate competition.

WHAT IS SUBSTANTIAL MARKET POWER?

Substantial market power is the ability to act unilaterally without effective competitive constraint.

For example, a business with substantial market power will be able to remain profitable while engaging in the following behaviour:

- Charging supra-competitive prices.
- Reducing the quality of products.
- Reducing the variety of products.
- Lowering customer service standards.

In a competitive market, in face of an increase in price or deterioration in the quality of goods or services offered, customers will bargain for a better deal, or switch to other suppliers. However, businesses with substantial market power can reduce the attractiveness of their competitive offering without resulting in a significant loss of business. This may be due to a number of reasons, for example the lack of countervailing buyer power or a lack of close substitutes for the relevant product or service, or, the cost to customers of switching is prohibitively high.

Under the Competition Ordinance, businesses with an annual turnover of HKD 40 million or less are exempted from the application of the Second Conduct Rule.

WHAT CONSTITUTES ABUSE?

There is nothing wrong with achieving market power by being better, more efficient, and more successful than the rest of the market.

Problems arise only when, having legitimately attained a position of substantial market power, a business attempts to maintain that position in an evolving market, not by competing on merit, but by misusing its power to exclude competitors.

To illustrate, the following conduct may constitute exclusionary abuse of market power:

<table>
<thead>
<tr>
<th>PREDATORY PRICING</th>
<th>Selling at unreasonably low (below-cost) prices to poach customers from competitors and gain market share, with the aim of restoring prices once competitors are driven out.</th>
</tr>
</thead>
<tbody>
<tr>
<td>TYING OR BUNDLING</td>
<td>Tying or bundling allows a business to leverage its market power into a related market (in which it does not enjoy substantial market power) by: 1. Forcing customers to buy several products/services as a “package deal”; or 2. Making the sale of one product/service conditional upon the purchase of others.</td>
</tr>
<tr>
<td>EXCLUSIVITY AGREEMENTS</td>
<td>Exclusivity agreements involving businesses with substantial market power are potentially anti-competitive because they tie up a substantial portion of the market. Competitors or potential new competitors may face exclusion from the market if they are unable to access a key resource, which may be the supply of an input, the right to license technology, or a key distribution channel etc.</td>
</tr>
<tr>
<td>LOYALTY REBATES</td>
<td>Discounts or rebates may be “loyalty inducing”, i.e., promote a de facto exclusive relationship, if they are calculated to induce a customer to purchase all of its requirements from one supplier.</td>
</tr>
</tbody>
</table>
Refusal to deal may take the form of:
1. Refusing to supply an (often important) input to a competitor, where the input is essential to the operation of the competitor or the refusal is made on a discriminatory basis; or
2. Refusing to do business with a customer or supplier unless the customer or supplier agrees not to deal with a competitor.

Having looked at what market power means and the types of conduct that could be seen as an abuse of that power. In the next article, we will consider how market power is assessed.

16. Market Power

We mentioned in the last article that businesses with a substantial degree of market power are under a special responsibility not to abuse their power. To find out whether this special responsibility applies to you, the first step is to assess the degree of market power you enjoy in the markets in which you are active.

**WHAT IS THE MARKET?**

Identifying the relevant geographical and product market is a good starting point for assessing market power.

Market definition is mainly determined by demand- and supply-side substitution. When the price of a product/service increases, or its quality is reduced, customers tend to switch to lower-priced or better-quality rival products/services. The number of substitutes for a given product/service inform how wide or narrow the relevant market is, and their location determines the geographical boundaries of that market.

By way of example, an increase in the price of a product in Hong Kong may lead to customers turning to brands in other countries, such as China or even the United Kingdom or United States, which provide international shipping services. In that scenario an argument may be made that the geographical market for the product is not confined to Hong Kong, but may be worldwide insofar as sellers offer a competitive international shipping service.
WHAT IS YOUR MARKET SHARE?
Market share is closely correlated to the degree of power a business enjoys in a relevant market. It is, however, not a conclusive indicator of market power, as the conditions of competition may evolve over time:

- In a dynamic market where innovation and new competitors constantly challenge the competitive landscape and consumers are reasonably informed and responsive to changes in the market, a high market share may not translate to market power.
- Where the market is slow moving, opaque or differentiated, a low market share would not preclude the existence of market power.

An accurate assessment of market power should take into account changes in market share over time, as well as other factors that characterise the market.

ARE THERE EFFECTIVE COMPETITIVE CONSTRAINTS?
The presence of the following features tends to contain the exercise of market power:

<table>
<thead>
<tr>
<th>POTENTIAL COMPETITION</th>
<th>The threat of potential market entry can keep existing competitors in check.</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXISTING COMPETITION</td>
<td>The strength of competitors make it difficult for businesses to raise prices or skimp on product quality.</td>
</tr>
<tr>
<td>BUYER POWER</td>
<td>The buyer’s bargaining power vis a vis the seller, is often an effective countervailing power against the market power of the seller.</td>
</tr>
<tr>
<td>GOVERNMENT REGULATION</td>
<td>Government regulation may limit the autonomy of a regulated entity to compete.</td>
</tr>
</tbody>
</table>

HOW OPEN AND COMPETITIVE IS THE MARKET?
Potential competition is an important driving force of competition and the mere anticipation of likely and timely new competition may be a sufficient constraint to market power. It follows that the existence of impediments to market entry and expansion may insulate existing competitors from competition and protect incumbent market power. These barriers will be considered significant if they substantially delay or prevent market entry or expansion.

Practitioners and economists have different views on what should constitute an entry barrier. For the purpose of competition analysis, the operative question is the extent to which a potential entrant will be deterred or delayed by asymmetries in a market that favour incumbent firms.

Direct barriers such as government regulation (e.g., control of licences) may be insurmountable and foreclose new competition outright. Other barriers, such as the prevalence of exclusivity relationships in the market and high, irreversible investment cost, may make market entry more difficult by lowering the likelihood of post-entry/expansion profitability.

In the next article we will take a look at predatory pricing, which is a form of abuse of market power.
17. Predatory Pricing

CAN LOW PRICES EVER BE A BAD THING?

Price wars among competitors are often a positive sign of healthy competition. As businesses undercut each other on price, consumers benefit from more affordable goods and services.

Although it rarely happens, excessively low prices may harm competition when a dominant business deploys a below-cost pricing strategy to damage a competitor, drive an existing competitor out of the market, and deter potential competitors from entering. Smaller competitors may not have deep enough pockets to compete with a powerful business, and, when equally efficient, but smaller competitors are driven out of the market, the predating business can strengthen its market power to raise prices and exploit consumers. Ultimately, consumers may be left with fewer choices, higher prices or reduced quality of goods and services.

WHEN DOES LOW PRICING CROSS THE LINE TO BECOME PREDATORY PRICING?

Competition law recognises that aggressive discounting and price cutting are essential, pro-competitive behaviour and generally indicate the existence of a healthy market.

Businesses may be able to afford to price lower than the competition because they are more efficient or face lower costs of production.

Thus it is not sufficient for a competitor to complain that lower prices in the market are making life difficult. A number of criteria must be met before a pricing strategy can be considered predatory:

- A business with substantial market power prices a product or service below cost.
- The purpose of selling below-cost is to damage, or eliminate the competition; and
- Below-cost pricing is sustained long enough that as a result:
  - Existing competitors have exited the market;
  - New competitors are unable to enter the market; or
  - Competitors are unable to compete effectively.

In some markets predatory pricing may not be a viable strategy at all. The following market characteristics may prevent a business from recouping its losses after implementing a predatory pricing strategy:

- There are many competitors, or other competitors with market power – a predatory pricing strategy is unlikely to effectively damage the competition.
- Entry barriers are low – competitors can easily re-enter, or new competitors may enter the market after prices return to normal levels.

In the absence of a likelihood of recoupment of losses, a predatory pricing strategy would make little commercial sense.

ARE THERE JUSTIFICATIONS FOR BELOW-COST PRICING?

Genuine commercial justifications for below-cost pricing may rebut an allegation of predation or justify the effects of such pricing on the competition.

The following are legitimate reasons for a limited duration of below-cost pricing:

- The pricing strategy is connected to the introduction of a new product or service.
- Below-cost pricing is required to penetrate a new market.
- The pricing strategy is necessary to meet the competition.
- The goods sold below-cost are perishable or damaged inventory.

In the next article we will take a look at anti-competitive tying and bundling.

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9 In this regard, the Competition Commission has indicated that it will consider pricing below average variable cost unlikely to be economically rational, but pricing below average total cost may be legitimate commercial behavior.
18. Tying and Bundling

WHAT IS TYING?
Tying is the sale of one product conditional upon the purchase of another. At a wholesale level, tying occurs if a supplier agrees to sell one product to a distributor on condition that the distributor purchases all of its requirements of a separate product from the supplier.

WHAT IS BUNDLING?
Bundling is the sale of two products as a packaged discount. The buyer is typically free to purchase one product separately, but at a higher price. At a wholesale level, bundling occurs when a supplier offers a discount to a distributor for purchasing its requirements of two separate products together.

WHAT PROBLEMS CAN ARISE FROM TYING AND BUNDLING?
Tying and bundling are, more often than not, beneficial to consumers. Selling related products together may result in costs savings from packaging and marketing, which may be passed on to the consumer. Both the seller and buyer may benefit from reduced search, information and transaction costs, and increased product range.

Concerns may arise when a business with substantial market power uses tying and bundling as means to leverage its market power from the market in which it has substantial market power (the dominant market) into a related market in which it does not have market power (the secondary market).

By tying or bundling the secondary market to the dominant market, a business with substantial market power may be able to harm competing suppliers by reducing the number of willing buyers available in the secondary market. As a result, competing suppliers in the secondary market may become less effective or even exit the market, potentially leading to higher prices for consumers.

Limited-duration tying or bundling, such as to promote the introduction of a new product or to clear inventory or damaged goods, is unlikely to cause anti-competitive effects.

In the next article we will take a look at exclusive dealing by businesses possessing a substantial degree of market power.
19. Exclusive Dealing

WHAT IS EXCLUSIVE DEALING?

Exclusive dealing is a vertical arrangement where one party is obligated to deal exclusively with another party, to the exclusion of their competitors.

Some exclusive dealing arrangements take the form of direct contractual obligations, such as exclusive purchase/supply obligations or quantity commitments, while others, such as loyalty rebates, may have the de facto effect of exclusivity.

WHEN DOES EXCLUSIVE DEALING AMOUNT TO ABUSE?

Under the Second Conduct Rule, the Competition Commission considers exclusive dealing likely to raise competition concerns if the following conditions are met:

i. The party has a substantial degree of market power and has imposed exclusivity obligations on many customers;
ii. It is likely that customers as a whole will not derive benefit; and
iii. A significant portion of the market is foreclosed to competitors.

Other factors to be taken into consideration include:

• The duration of exclusivity;
• The market power of the other party to the relationship; and
• The prevalence of other exclusivity arrangements on the market.

Actual anti-competitive effects on the market, such as an increase in prices or the exit of as-efficient competitors from the market, are strong indicators that an exclusivity arrangement constitutes an abuse of substantial market power.

CONDITIONAL REBATES

Conditional rebates are quantity-based rebates designed to induce customer loyalty. In some cases conditional rebates may lead to de facto exclusivity, when a customer deals exclusively with a seller in order to reach the requisite purchase volume for the rebate to kick in.

Volume rebates are generally pro-competitive when they are relatable to economics of scale and cost savings. Incremental and non-discriminatory discounts will rarely be considered anti-competitive.

Conditional rebates are only likely to harm competition if they are retroactive or individualised:

• Retroactive rebates are “all-or-nothing” rebates where customers are only entitled to claim on their entire purchase order if they reach a purchasing target during a period.
• Individualised rebates are tailored to the particular requirements of each customer and designed to lock in customers across a spectrum of needs to purchase exclusively from the seller.

Unlike incremental discounts, retroactive or individualised rebates go further than passing on the seller’s cost savings to the customer.

IT’S NOT ALL BAD NEWS

Exclusive dealing, like many vertical relationships, is common and may be pro-competitive. It may:

• Promote efficiency by creating competition in the process of forming “teams”;
• Encourage distributors or retailers to focus on marketing a product, promoting inter-brand competition; and
• Stimulate market demand and benefit consumers.

In the next article we will take a look at refusals to deal.
20. Refusal to Deal

**REFUSAL TO DEAL**

Businesses are generally free to decide with whom they will do business. Refusal to deal may be problematic when a business with a substantial degree of market power controls an essential input or distribution channel, and, by withholding that input or preventing access to the distribution channel, forecloses a business from the relevant market or damages its ability to compete effectively in that market.

**WHEN CAN YOU SAY NO?**

A business with substantial market power may legitimately refuse to deal with a party if the party:

- Is not reliable, e.g., is a bad credit risk.
- Lacks requisite capability, e.g., is unable to provide sufficient customer or after-sales service.
- Does not meet reasonable, objective and fairly applied criteria, e.g., advertising and product display criteria.

**WHEN MAY REFUSAL TO DEAL BECOME AN ISSUE?**

Only in very rare cases will a refusal to deal contravene the Second Conduct Rule. The Competition Commission may consider:

1. Whether or not it is technically and economically feasible for the business to provide the input.
2. The history of dealing between the parties – whether a business relationship was abruptly terminated without justification.
3. The terms and conditions at which the products are generally supplied, or are supplied in other contexts.

Exceptionally, a business may be under a duty to deal on non-discriminatory terms with a competitor or potential competitor if the input it controls is so important that without access to it other businesses will be unable to compete.

This may arise in the intellectual property context, where a business holding an essential intellectual property right (IPR) agrees to allow the IPR to be incorporated into an industry standard and license the IPR on fair, reasonable and non-discriminatory terms, but subsequently reneges on its promise or seeks to restrain use of the IPR by a willing licensee.

In the next article we will consider margin squeeze, a form of exclusionary abuse where a business with substantial market power in an upstream market seeks to leverage its market power into a related downstream market.
21. Margin Squeeze

Margin squeeze is a form of exclusionary abuse where a (fully or partially) vertically integrated business controlling a key input or facility in the upstream market sells that input to its downstream rivals a substantially higher price on significantly unfavourable terms, to strengthen its own market power in the downstream market and hamper the ability of downstream rivals to compete effectively.

WHEN IS MARGIN SQUEEZE HARMFUL TO COMPETITION?
Margin squeeze is a common practice in Hong Kong, and will only contravene competition law in very narrow circumstances. When assessing whether a margin squeeze may amount to abuse, the Competition Commission will consider:

1. The nature of the upstream input or facility.
   » The more important the input or facility and the more substantial it is as a proportion of overall production cost in the downstream market, the greater the potential negative impact on competition in the downstream market.
   » Supplying a key input or facility at unreasonable terms is akin to a constructive refusal to deal, which is unlikely to be problematic unless the business has a duty to deal in the first place.

2. The size of the margin squeeze.
   » Competition in the downstream market may be restricted where the business with substantial market power in the upstream market:
     • Sells an input to its downstream rivals at a price which exceeds the price at which it sells the end-product in the downstream market.
     • Uses profits from inflated prices charged to downstream rivals to subsidise its own cost of production, in order to sell the end-product at a below-cost price in the downstream market.

WE HOPE YOU ENJOYED THE SERIES!
This is the end of our Hong Kong Competition Law Series. We hope you found the articles useful and informative.

The Competition Ordinance (Cap.619) is currently set to come into force on 14 December 2015. For inquiries related to the Hong Kong Competition Law Series, please contact the following persons or your usual contacts at our firm.

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