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China's Anti-Monopoly Law Merger Control Regime - 10 Key Questions Answered (Part II)

This is the second in a two-part update series in which we provide answers to some of the more common questions international business operators have raised about the AML merger control regime, based on our insights from working with the regime for the past 19 months.

In Part I of this series, available here, we addressed the following five questions:

- Is the regime being applied equally to foreign and domestic Chinese firms?
- Have any business operators been fined for non-compliance with the regime?
- What is the clearance rate for notified deals?
- What is the likely timeframe for a Mofcom decision?
- Is there any prospect of 'short form' notification or 'expedited' review for deals that do not appear to have any real China nexus?

In this second update, we provide responses to five further questions, as well as compliance tips of general application.

Question 6

WHAT TYPES OF TRANSACTIONS WILL BE SUBJECT TO CLOSE SCRUTINY?

China's merger control system is evolving, and thus far just 6 decisions have been published by Mofcom's Anti-Monopoly Bureau. Nonetheless, it is already possible to identify several categories of transactions that may be subject to heightened scrutiny by Mofcom based on relevant wording in the law and Mofcom's decision statements to date. These transaction categories will not be surprising to business operators familiar with other mature merger control systems, however some elements of Mofcom's approach to reviewing transactions - and the remedies it may seek to impose for those deals raising significant concerns - are noteworthy.

Transactions involving horizontal overlaps

Three of the deals that Mofcom has cleared subject to conditions have been between parties with significant business overlaps. Specifically:

a. The Mitsubishi Rayon / Lucite deal involved significant overlaps in the manufacture and distribution of methyl methacrylate ("MMA") in China (used in the manufacture of plastics) as well as minor overlaps in other China markets including those relating to specific sulfopropyl methacrylates ("SpMAs") and polymethyl methacrylate ("PMMA") particle and panel products. In relation to MMA, Mofcom found that the merged entity would supply approximately 64 percent of the relevant market in China, and that this share was significantly larger than those of the second and third largest suppliers in China (Jilin Petrochemical and Heilongjiang Longxin Company).

b. The Sanyo / Panasonic deal involved overlaps in relation to several product categories.

Specifically, Mofcom identified that through the combination of the parties' existing operations the merged entity (in conjunction with relevant affiliates) would have a market share in China of 46.4 percent for rechargeable portable nickel metal hydride batteries, 61.6 percent for coin-shaped rechargeable lithium batteries, and 77 percent for rechargeable nickel metal-hydride batteries for automotive use.

c. The Pfizer / Wyeth deal involved overlaps in relation to production of a swine mycoplasmal pneumonia vaccine, with Mofcom determining that the merged entity would have a combined market share of 49.4 percent in this market in China, significantly higher than the next largest rival in the market, Intervet (part of Akzo Nobel) which holds an 18.35 percent share.

The decisions in these cases reflect Mofcom's tendency to rely on high market shares to presume market power and establish a *prima facie* case for imposing conditions on deals. Accordingly, business operators should be aware of the fact that the decisions handed down so far indicate any horizontal merger which will result in the merged entity increasing its share of a relevant market in China above 45 percent (and doubtless, even lower in some future cases) is likely to attract considerable Mofcom scrutiny, particularly if the other leading competitors in that market have substantially lower market shares.

This is broadly consistent with the market share thresholds for presuming market dominance that are set out in Article 19 of the AML. Pursuant to these provisions, a business operator with a market share exceeding 50 percent will trigger the presumption, as well as any business operator with a lower market share who is nonetheless a key supplier in a highly concentrated market (i.e. two business operators combined account for at least 66 percent of the market, or three business operators combined account for at least 75 percent of the market). Interestingly, recent Mofcom decisions indicate the regulator is also placing increasing weight on a commonly accepted measure of market concentration, the Herfindahl-Hirschman Index (or 'HHI' as it is often known), to assess the competitive impact of deals where the merged entity will have a market share of less than 50 percent.

In cases where the merged entity is presumed to enjoy dominance post-transaction, Mofcom may be considered likely to assume (in the absence of clear evidence to the contrary) that this entity may not be adequately constrained from unilaterally raising prices, and may in relevant cases be able to significantly limit downstream supply or further marginalise sales of competitors. Accordingly, business operators notifying such a deal to Mofcom will need to present a convincing case to avoid the imposition of conditions. Based on its decisions to date, Mofcom is likely to otherwise consider imposing remedies such as divestment of some capacity divestiture, or restrictions on further acquisitions in the relevant sector (or even, most concerningly, on organic growth, such as occurred in the Mitsubishi Rayon / Lucite case - where Mofcom ordered that the post-merger Mitsubishi Rayon may not build new MMA-related manufacturing plants in China without prior approval).

It also needs to be noted that Mofcom has evidenced a willingness to impose conditions on deals even where its analysis of those deals fails to identify that they will lead to competitive harm.

For example, in the InBev / Anheuser deal, the merging parties were both active in China's beer market, although market researchers have estimated that their combined market share immediately prior to consummation of the deal was just 13 percent. Nonetheless, Mofcom decided to attach conditions to the deal (which, for example, restrict the merged party from taking a further stake in specific Chinese brewers without prior Mofcom approval) on the apparent basis that any *further* China-focussed M&A by the merged party might lead to an unhealthy level

of market concentration. This type of 'forward looking' condition is highly unusual from a Western antitrust perspective.

Transactions raising vertical issues

Several Mofcom decision to date have dealt with what are commonly termed 'vertical' competition issues, in which products manufactured and/or sold by merging parties are not substitutes - but are somehow vertically related or complementary to one another. For example:

- In the GM / Delphi case, Mofcom concluded that GM held a leading position in the market for passenger vehicles in China, while Delphi was itself a leading player in a number of different markets in China relating to the manufacture and sale of car parts. Consequently, Mofcom imposed conditions on the proposed merger between these two business operators to alleviate its concern that an unrestricted combination could lead to GM's rivals being foreclosed access to Delphi car parts, whilst Delphi's competitors might also have restricted sales opportunities (as GM might want to favour in-house supplies from Delphi).
- In the Mitsubishi Rayon / Lucite, Mofcom concluded that, post-closing, Mitsubishi Rayon would be able to use its dominant position in the upstream MMA market to foreclose competition in two downstream markets (for PMMA particle and panel products) in which it was also active.
- In the Coca-Cola/Huiyuan case, a key reason for Mofcom's decision to prohibit the deal (according to its decision statement) was that the complimentary nature of the parties' products would allow Coca-Cola to 'leverage' (through product tying and other exclusionary conduct) its market power in the carbonated soft drinks market in China into the domestic fruit juice market in which Huiyuan had a strong position.

Accordingly, business operators holding a relatively strong position in one or more markets in China can expect heightened scrutiny by Mofcom of any M&A transactions they conduct with parties who have a vertically related product portfolio. This should be no surprise to business operators with experience of other mature antitrust regimes. However, whereas the burden of establishing that there a is high risk of vertical foreclosure or other competitive harm (such as through leveraging practices) will usually fall on the regulator in other jurisdictions, and require satisfaction of a high burden of proof, it is not clear that the same advantage exists for transaction parties submitting to China's merger control regime.

Consistent with the tendency for Mofcom's decision statements to read as a series of conclusions, rather than evidencing any substantive assessment and analysis, the decisions in each of the three cases mentioned above generally jump directly from a finding that one of the transaction parties has a high market share in respect of one product (or relevant group of products) and move straight to an assumption that the business operator will therefore be able to engage in vertical foreclosure or leveraging.

Accordingly, business operators involved in transactions that may be seen to raise vertical issues will need to be proactive in anticipating, and presenting compelling evidence to rebut, assumptions of competitive harm that Mofcom may be inclined to draw from the basic fact matrix.

Foreign investment in, or takeovers of, famous or economically significant Chinese enterprises

In Part I of this update series, we noted that the AML provides for transactions to undergo "national security" review if they affect "key industrial sectors" in China" or " the "national economy," or involve "well known trademarks or traditional brands" of China. As a consequence, it is considered very likely that foreign acquisitions of (or investment in) high-profile or economically significant Chinese companies will face considerable scrutiny under the law.

To date, it is not clear that any transaction has been reviewed under the relevant AML provisions. However, there is speculation that industrial policy considerations played a role in Mofcom's review of the Coca-Cola / Huiyuan case - and it may not always be possible to draw a clear distinction between Mofcom's competition-focussed review and the notionally separate national security review of transactions provided for in the AML.

At this stage, it is clear the Chinese authorities are generally reluctant to allow foreign takeovers of prominent domestic Chinese companies unless those transactions offer the prospect of otherwise unattainable financial assistance or management expertise, and thus it may be unlikely that Mofcom will allow deals of this nature to pass through merger review unchallenged.

Accordingly, business operators contemplating the purchase of, or investment in, prominent domestic Chinese companies will need to be mindful of the prospects of a lengthy review period, take steps to try and manage adverse coverage of the deal by the Chinese media and public opposition more generally, and try and secure the support of relevant influential industry organisations or customer representative groups in China.

Question 7

HAS MOFCOM CLARIFIED THE EXTENT TO WHICH MINORITY SHARE ACQUISITIONS MUST BE NOTIFIED FOR REVIEW?

The extent to which minority share acquisitions must be notified to Mofcom for review remains unclear.

Under Article 20 of the AML, a 'concentration' (being the term used in the AML for transactions requiring notification if implemented between business operators who achieve relevant turnover thresholds) is defined as including, inter alia:

- The acquisition of control over another business operator via the purchase of shares or assets
- The acquisition of control, or the ability to exercise determinative effects, over a business operator by contract or other means

Draft implementation measures expanding on this definition were published by MOFCOM in January 2009, and these draft rules explained how the phrase "acquisition of control" should be interpreted. Amongst other things, the draft measures provided that an acquisition of control will occur where a business operator acquires less than 50% of the voting shares of another business operator (the target) but also gains the ability (through contractual rights or other means) to do any of the following:

- Decide the nomination of one or more directors or other core members of the target
- Decide the target's financial budget, operation and sales, product pricing or significant investment
- Make decisions on significant management and operational matters, for the target

In focussing on whether or not a business operator making only a minority share acquisition nonetheless obtained the ability to decide important management and operation policies, the draft measures were largely in alignment with the test for identifying a 'concentration' under the EU's merger control regime.

Although there were several ambiguous and uncertain aspects of these draft measures, they did provide a useful level of guidance regarding the types of transactions that Mofcom considered would be likely to warrant notification and review under the AML. In many cases, businesses engaging in transactions that clearly fell outside the criteria for "acquisition of control" described in the draft measures, could be sufficiently satisfied that their deal was not required to be submitted to Mofcom and that no consultation with the regulator was necessary on this issue.

Unfortunately, finalised versions of the relevant important measures (the *Measures for the Review of Concentrations of Business Operators and Measures for the Reporting of Concentrations of Business Operators*), which were issued by Mofcom on 27 November 2009 and took effect on 1 January 2010, now omit any definition or explanation of the phrase "acquisition of control".

Accordingly, there remains no official guidance from the Chinese authorities on this point, and the high level of uncertainty that existed immediately after the commencement of the AML in August 2008 (and before publication of the draft measures in January 2009) regarding which minority share acquisitions will qualify as concentrations under the AML has now returned.

It is considered likely that Mofcom will revisit this issue in later guidelines or measures, and that the relevant provisions that appeared in the draft Notification Measures were removed from the finalised version due to continuing debate within Mofcom and associated agencies about the scope of deals that should properly fall for review under the AML's merger control regime.

In the meantime, the uncertainty created by the removal of the definition means companies may need to consult with Mofcom before going ahead with many deals, even those that concern only minority share acquisitions.

The move may also be viewed as giving Mofcom more discretion to investigate transactions in which it is particularly interested.

Question 8

IS MOFCOM FOLLOWING EUROPE'S LEAD IN MAKING A DISTINCTION BETWEEN "FULL FUNCTION" AND "PARTIAL FUNCTION" JOINT VENTURES UNDER THE AML MERGER REVIEW PROCESS?

Mofcom's recently finalised *Measures for the Reporting of Concentrations of Business Operators* mentioned in the response to Question 7 fail to include any guidance on how joint ventures will be treated under China's merger control regime. As the text of the AML itself also does not address the question of which joint ventures may qualify as a 'concentration', there remains considerable uncertainty on this issue.

A draft version of the aforementioned measures, published in January 2009, stipulated that the joint establishment of a new entity by two or more business operators did qualify as a concentration. In the lead up to finalisation of this draft, there was much speculation that the relevant provisions may be amended to make a distinction between "full function" and "partial function" joint ventures. This would have effectively mirrored the prevailing European position on this issue, pursuant to which only the creation of a joint venture performing on a lasting basis all the functions of an autonomous economic entity (as distinct, for example, from special purpose joint venture entities assuming certain specific functions for the parents, such as research and development or distribution) would constitute a concentration.

However, this did not occur. Instead, the entire provision mentioning joint ventures was removed from the finalised draft of the relevant measures.

Some analysts have suggested that this means all newly established joint ventures should be assumed to qualify as a concentration, on the basis that they can be argued to satisfy the definition of the term 'concentration' in Article 20 of the AML ("obtaining control of or the capability to exercise decisive influence over other undertakings by contract or other means")

If this is the case, a joint venture that would be considered "competitive" and not subject to merger control in the EU might require notification in China.

In practical terms, the main implication for the business sector from this omission is that, as with relevant minority share acquisitions, new joint ventures between business operators that meet China's mandatory notification turnover thresholds may now have to be the subject of formal or informal consultation with Mofcom - in order for parties to obtain clear guidance on whether Mofcom believes it should be the subject of a notification.

Moreover, to avoid risk, it will not be sufficient to assume that transactions which do not qualify as a 'concentration' under competition regimes with broadly analogous mandatory notification criteria (such as the European Union) will also be considered by Mofcom to fall outside the scope of its merger review powers.

Question 9

DOES MOFCOM HAVE REGARD TO THE DECISIONS OF OTHER FOREIGN ANTITRUST REGULATORS, OR ACCEPT INPUT FROM OTHER INTERESTED PARTIES?

It is clear that Mofcom has consulted the decisions of other jurisdictions' antitrust agencies when formulating its decisions under the AML merger control regime.

For example, in the *Coca-Cola/Huiyuan* case, there is evidence suggesting Mofcom closely considered a decision made by the Australian Competition & Consumer Commission in 2003 (to block the proposed acquisition of leading Australian juice manufacturer Berri Ltd by Coca-Cola Amatil Ltd) when formulating its decision. Indeed, Mofcom representatives have expressly referred to this Australian decision when justifying their own prohibition decision in press conferences.

Notwithstanding this, it is usually prudent for business operators to avoid the inclusion of language in their China antitrust filings that may be interpreted by Mofcom as a suggestion that they should follow (or would be 'out of step' in not following) the precedents set by foreign regulatory decisions. Mofcom is understood to be particularly sensitive to this type of practice, and accordingly reliance on 'foreign precedent' in PRC filings should be limited to efforts to convey relevant aspects of the substantive reasoning behind foreign decisions (as applicable to the transaction being filed and the competition issues it may raise), without using express 'case citations'.

In-person consultation with Mofcom officials may then be a more favourable forum in which favourable precedent decisions from other jurisdictions can be specifically brought to the attention of Mofcom officials. Of course, care still needs to be taken to ensure this is not done in a manner which may be interpreted as suggesting Mofcom should defer to a position taken under a foreign regime.

Regarding the issue of whether Mofcom accepts input from 'interested parties', the answer is that there is clear evidence such input is becoming more important to Mofcom's review process over time.

The *Measures for the Review of Concentrations of Business Operators* clearly state that Mofcom is entitled to seek the opinions of stakeholders (such as other government departments, industry associations, business operators and customers) and can gather third-party information through a combination of interviews, written questionnaires and oral hearings. Indeed, Mofcom's practices in more recent cases indicate that oral hearings are playing an increasingly important role in the review process - as a forum through which competitors and other interested parties can confidentially 'air their views' about a relevant transaction under review.

Mofcom will generally be proactive in contacting relevant trade associations and key competitors of merging parties in China to ascertain their views about such a transaction (and the accuracy of significant information submitted by the transaction parties in a filing), and may invite such parties to attend relevant oral hearings. Additionally, other

interested parties may themselves initiate contact with Mofcom and request to make a submission or be involved in hearings or other aspects of the process.

Question 10

WHAT ARE THE NEXT BIG DEVELOPMENTS WE CAN EXPECT TO SEE?

As noted in our comments in relation to questions 7 and 8 above, a number of key aspects of China's merger control regime remain uncertain and are in need of clarification. It is expected that Mofcom will publish further measures or guidance documents during 2010 to address at least some of these issues, and it is also understood that Mofcom is developing further substantive guidance regarding how it analyzes the competitive effects of transactions. These documents will be eagerly awaited by many observers and subjects of the regime.

It is also expected that Mofcom will continue with many of the capacity-building efforts that it undertook during 2009, such as extensive training of staff with assistance from antitrust regulators in the US, EU, Japan and elsewhere. Additionally, as officials become more confident and skilled in their assessment process, the trend of Mofcom issuing longer and more detailed decision statements is expected to continue. This can only aid Mofcom's efforts to counter criticism about a lack of transparency surrounding its decision making process and speculation that its decisions are unduly impacted by industrial policy concerns.

In terms of potential 'headline' decisions, observers are currently watching with interest for the outcome of Mofcom's analysis of the HP/3Com merger. This deal was the subject of a joint AML notification by HP and 3Com to Mofcom on 4 December 2009, and Mofcom formally accepted the notification on 28 December 2009. On 25 January 2010, Mofcom informed the parties that it was initiating 'Phase II' review, which under normal circumstances would be completed by the end of April 2010 (but may be extended for a further two months in certain circumstances). There has been significant speculation that the prospects for Mofcom approval of this deal may be clouded given the collapse of the Chinese company Huawei Technologies, attempt to invest in 3Com in 2007 following the transaction review by CFIUS under the U.S. Foreign Investment and National Security Act.

Additionally, it is expected that we will soon learn whether or not Mofcom will review the proposed BHP/Rio Tinto production joint venture in Western Australia. The issue of whether or not Mofcom approval for this transaction is required has been unclear for many months, due to the uncertainties surrounding the treatment of joint ventures that are discussed in our comments in response to Question 8 above. If this case is reviewed, and Mofcom finds that it raises competition concerns, it will be interesting to see how Mofcom seeks to address these concerns given that neither BHP Billiton nor Rio Tinto has any meaningful assets in China (their commercial presence in China is limited to set-up of offices).

Observers of the AML regime will also watch with interest to see if Mofcom can garner sufficient political support in China to conduct intensive review of M&A deals between (or involving) China SOEs, or otherwise begin to take action in respect of any domestic deals that may raise competition issues.

Finally, it is noted that the Chinese authorities are expected to finalise IP Guidelines in the coming months, which should shed further light on how China's antitrust authorities - including Mofcom - will approach IP-related issues under the Anti-Monopoly Law. A draft version of these guidelines was circulated to key stakeholders towards the end of 2009, and included some provisions that will provide comfort to holders of significant IP rights (such as provisions stipulating that business operators should not be presumed to enjoy market dominance specifically due to their ownership of relevant IP

rights). However, the guidelines also provided for the possibility of a compulsory licensing requirement for IP holders, and some analysts remain concerned about the possibility that Mofcom could be encouraged to impose compulsory licensing conditions on mergers perceived to raise issues relating to the monopolization of technology.

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