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Client Alert

New Hong Kong Competition Ordinance

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New Hong Kong Competition Ordinance

Who should be aware of the new Competition Ordinance (Cap. 619) (CO)? – If you are operating a business offering goods or services in Hong Kong or considering acquiring one, it is important that you are aware of the new rules under the CO and plan for their introduction.

What does the new CO regulate? – Generally, it prohibits all contractual arrangements and business practices that have the object or effect of harming competition in Hong Kong. With respect to mergers, it only restricts telecommunications mergers. Examples of anti-competitive conduct include:

- **Price Fixing** – exchange of information on future price intentions, resale price restrictions imposed by suppliers on retailers, wage-fixing, price recommendation by trade associations, fee scales set by professional bodies
- **Market sharing** – dividing up a market e.g. by agreeing with competitors not to sell to each other's customers in order to be "sheltered" from competition in the allotted portion of the market
- **Output limitation** – production or sales quota arrangements involving competitors limiting the volume or types of products available in the market

When will the regulations come into force? – The CO was enacted in June 2012 and will be implemented in phases. The competition rules and the penalty provisions may come into force as early as the **second half of 2015**. *So, if you are now drafting contracts for 2015, start thinking about the contractual provisions with the new competition rules in mind*.

Consequences – A breach constitutes a civil (as opposed to criminal) offence carrying potentially severe penalties. In the worst case scenario, the maximum fine can be up to 10% of the infringing undertaking's Hong Kong turnover for a maximum period of three years. Such a penalty may be imposed on any person who has been "involved" in a contravention of a competition rule. In addition to potential fines, there will also be the obvious costs and expenses related to a person under investigation, costs and disruption to management and business.

What you should do now – from now to mid-2015, you should start thinking about:

- Creating an organisational awareness of the new competition rules
- Reviewing your company's existing contractual arrangements and business practices
- Considering any possible risks of non-compliance
- Taking steps to ensure compliance after the CO comes into effect, including updating internal compliance manuals and/or policies

Details of the competition rules – The CO provides for three major prohibitions:

The First Conduct Rule prohibits anti-competitive agreements or concerted practices (which cover cooperation between competitors that falls short of an agreement).

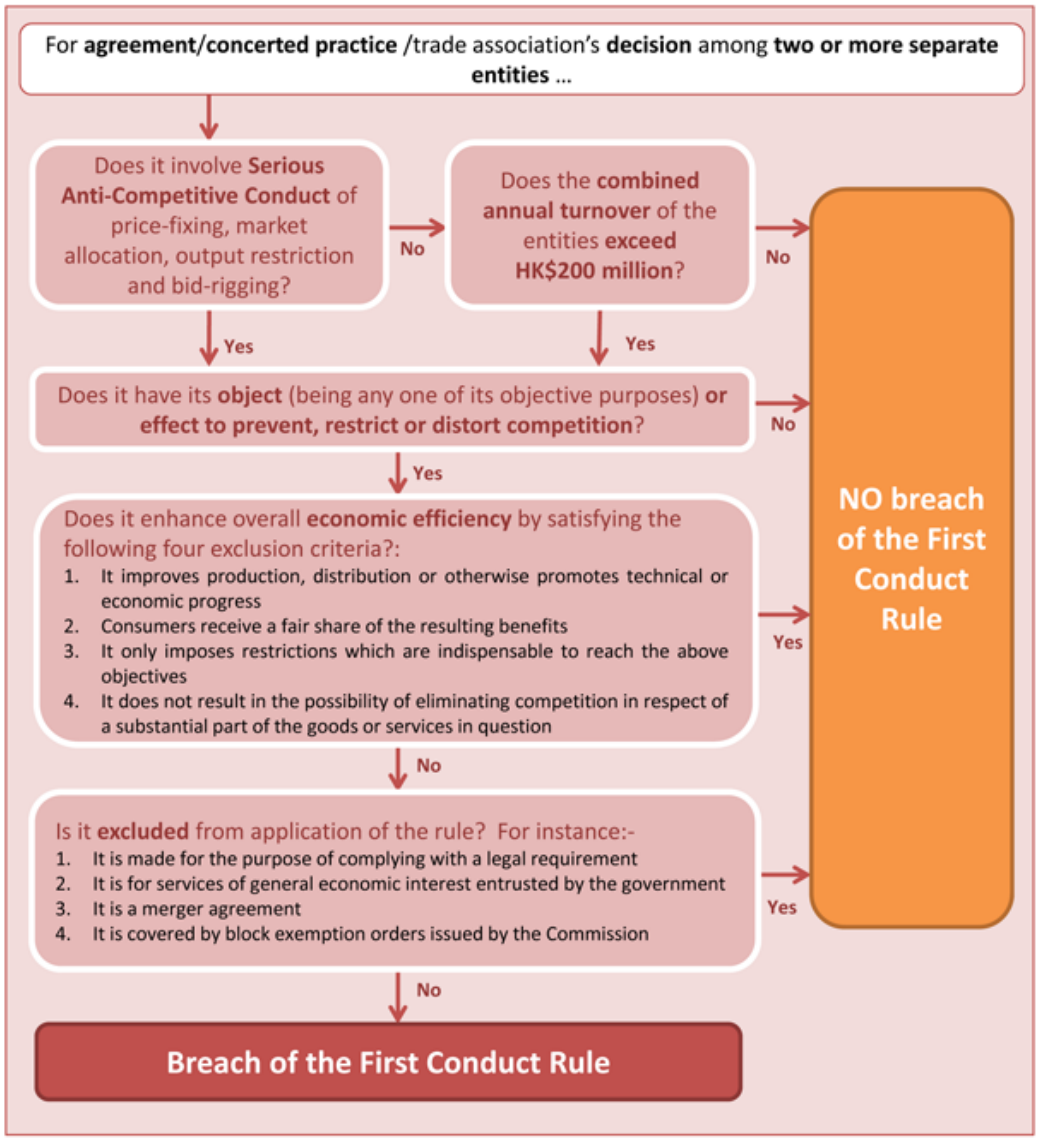
- It applies to both **horizontal agreements** (i.e. agreements between competing undertakings) and **vertical arrangements** (i.e. agreements between undertakings which operate at a different level of the production or distribution chain – for instance a supplier and a retailer)
- The First Conduct Rule distinguishes between **Serious Anti-competitive Conduct** and other conduct. Serious Anti-Competitive Conduct covers four specific activities, being:
  - **Price fixing** – fixing, maintaining, increasing, or controlling the price for the supply of goods or services, such as:
    - Agreement between competitors with respect to any element of price, including any discount, rebate, allowance, price concession or other advantage in relation to the supply or products
    - Exchange of information on future price intentions
    - Wage-fixing
    - Resale price restriction where supplier establishes a fixed or minimum resale price to be observed by the retailer
    - Price recommendation by trade associations, fee scales set by professional bodies
  - **Market sharing** – allocating sales, territories, customers or markets for the production or supply of goods or services, for instance, competitors agreeing:
    - Not to sell in each other's agreed territories
    - Not to sell to each other's customers
    - Not to compete in the production of certain products
  - **Output limitation** – fixing, maintaining, controlling, preventing, limiting or eliminating the production or supply of goods or services, e.g.
    - Production or sales quota arrangements involving competitors limiting the volume or types of products available in the market
    - Certain producers agreeing to withdraw from the production of a product in return for compensation payments
  - **Bid-rigging** – not competing with one another for a particular project but deciding which bidder will be the winner, for instance, an agreement between potential supplies that:
    - They will take turns at being the winning bidder
    - Certain bidders will submit higher big prices than the supplier "chosen" to win the tender
- **Other anti-competitive conduct** – generally requires an analysis of their actual or likely effects on competition. This may include:
  - **Exchange of information** – either directly or indirectly via customers and

suppliers, which results in undertakings becoming aware of the market strategies of their competitors (e.g. sharing information with competitors on price or elements of price, customers, staff wages, bonuses or intended pay rises, production costs, quantities, turnover, sales, capacity, product quality, marketing plans, risks, investments, technologies and innovations)

- **Group boycotts** – an agreement or cooperation amongst competitors to exclude an actual or potential competitor (which will be considered as having the object of harming competition)
- **Joint purchasing agreements** – agreements between competitors to purchase products jointly, where the parties together have market power on either the upstream purchasing or the relevant downstream markets
- **Standard terms and standardisation agreements** – competitors agreeing to use standard terms which define the scope or nature of the product sold (for instance, standard terms concerning risks to be covered by a particular category of insurance policy) may entail a risk of reduced innovation and product variety
- **Membership and certification restrictions** – excluding competitors from membership of an association which is an essential pre-condition for competing in a market with non-transparent/discriminatory rules of admission, which might be equivalent in effect to an anti-competitive boycott
- **Certain joint ventures** – anti-competitive arrangements between competitors through a jointly controlled legal entity (e.g. a production joint venture where producing jointly leads to reduced product variety, higher prices for the customers of the parents, an increase in the parties' commonality of costs or an exchange of competitively sensitive information)
- **Exclusive distribution or customer allocation agreements** – a supplier assigning exclusively for the resale of its products in a particular territory to a single distributor, which reduces competition between distributors for the same products/brands
- **Recommended and maximum resale price restrictions** – a supplier setting a recommended or maximum resale price which the distributors generally follow that softens competition between suppliers or otherwise facilitates coordination between suppliers

- The CO provides for various **exclusions and exemptions** from the First Conduct Rule – for instance, **agreements enhancing overall economic efficiency** are excluded from the First Conduct Rule
- For agreements among undertakings with a combined aggregate worldwide annual turnover not exceeding HK$200 million, the First Conduct Rule only applies in relation to Serious Anti-Competitive Conduct
- The Competition Commission may issue a **block exemption order** to exempt a particular category of agreements which enhance overall economic efficiency – however, there is no need for a prior Competition Commission decision or block exemption order for undertakings to take advantage of efficiency exclusion

THE FIRST CONDUCT RULE: Anti-Competitive Agreements



The Second Conduct Rule prohibits undertakings with a substantial degree of market power from abusing that power to prevent, restrict or distort competition.

- In order to determine whether an undertaking has a substantial degree of market power, it is necessary to define the specific market in question. The **market** will normally contain two dimensions: the product or service and its substitutes, and the geographical area (which may cover a global or regional area, or may be limited to Hong Kong or a part of Hong Kong).
- The Second Conduct Rule only applies to businesses with a **substantial degree of market power**. Undertakings with annual turnover not exceeding HK$40 million are excluded from the rule. However, there is no specific market share threshold which determines whether an undertaking holds a substantial degree of market power. Assessment of "substantial market power" will depend on:
  - The market share of the undertaking
  - The undertaking's power to make pricing and other decisions

  - Any barriers to entry or expansion to competitors into the relevant market
  - Countervailing buyer power
  - Market-specific characteristics
  - Any other relevant matters.

- Examples of specific forms of abuse include:
  - **Predatory pricing** – setting prices so low that the party concerned deliberately foregoes profits in an attempt to force one or more other undertakings out of the market and/or in an attempt to otherwise "discipline" competitors
  - **Tying and bundling** – making the sale of one product (the tying product) conditional upon the purchase of another (the tied product) as a means to harm competitors in the tied market, or bundling a package of two or more products at a discount
  - **Margin squeeze conduct** – where a vertically integrated undertaking supplies an important input in the downstream market in which it also operates, reducing or "squeezing" the margin between the price it charges for the input to its competitors on the downstream market and the price its downstream operations charge to its own customers, such that the downstream competitor is unable to compete effectively
  - **Refusals to deal** – refusing to supply an input to another undertaking, or being willing to supply that input only on objectively unreasonable terms
  - **Exclusive dealing (or rebates that have effects similar to exclusive dealing arrangements)** – preventing competitors from selling to customers through exclusive dealing arrangements (in the form of either an exclusive purchasing obligation or a conditional rebate such as fidelity/loyalty rebate), which require customers to purchase, directly or indirectly, all or a substantial proportion of their requirements of a particular product from a particular undertaking
  - **Discriminatory pricing** – offering different prices or terms to similar customers without objective justification.
- The CO provides **exclusions and exemptions** such as compliance with legal requirements and services of general economic interest.

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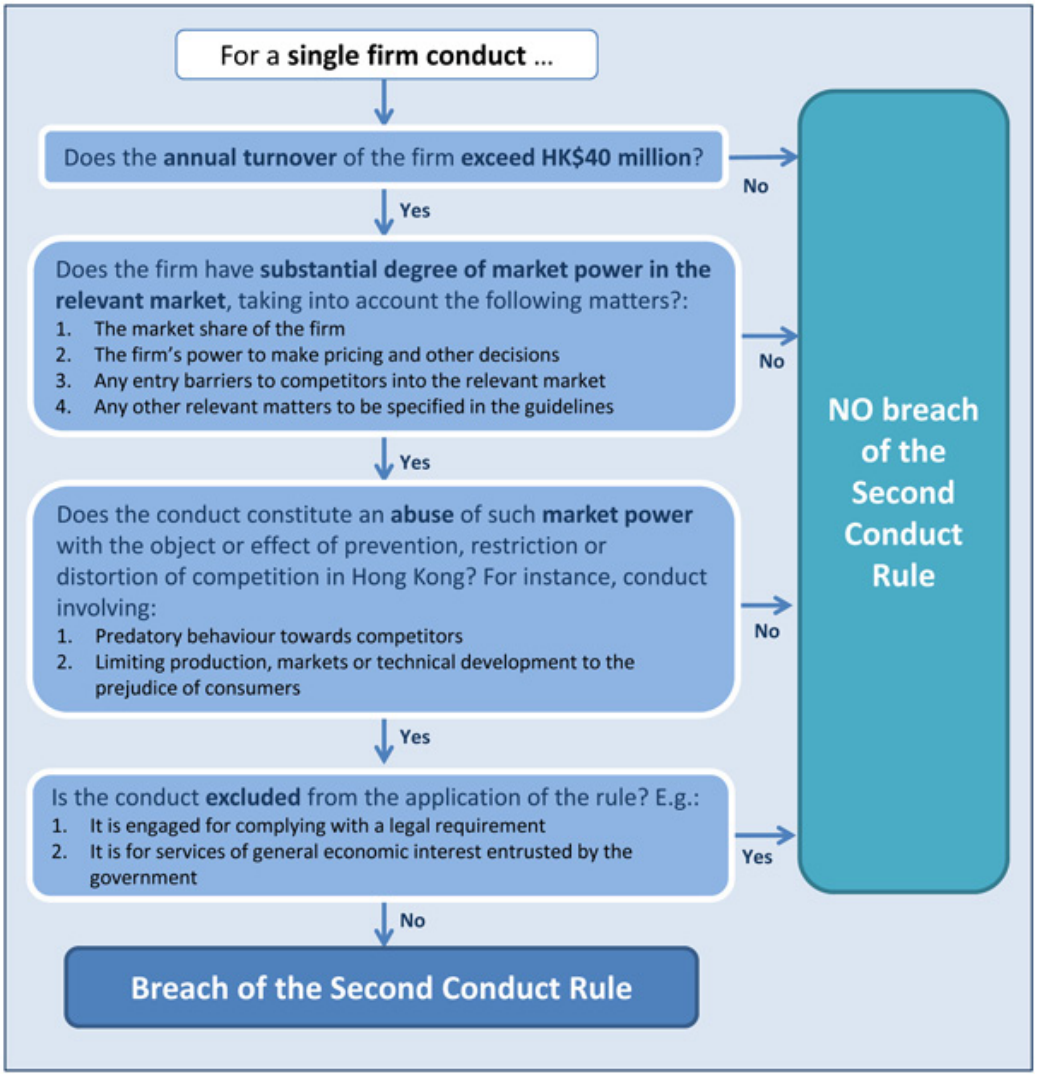
THE SECOND CONDUCT RULE: Abuse of Market Power



The Merger Rule is the only competition rule that does not apply to undertakings in all sectors. It only applies to mergers involving (directly or indirectly) holders of carrier licences under the Telecommunication Ordinance, which have or are likely to have the effect of substantially lessening competition in Hong Kong. As stated in the draft Guideline on the Merger Rule, the Competition Commission is unlikely to carry out an investigation or to intervene if the merged firm has a market share of less than 40% and a post-merger combined market share of the top largest firms is less than 75%. It is noted that these thresholds simply confirm the position previously adopted by the Telecommunications Authority.

Please note that this Alert aims to highlight some of the key implications for companies operating a business in Hong Kong and is not meant to be exhaustive. Please speak to your usual contact at Reed Smith Richards Butler if you require any advice.