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5 August 2011

Mr Gregory So, JP
Secretary for Commerce and Economic Development
Commerce and Economic Development Bureau
2/F, Murray Building
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Dear Greg

Competition Bill

Thank you for your letter of 25 July, signed on your behalf by Mr Raymond Wu. We have the following comments on the points contained in your letter.

"Prevent, restrict or distort competition" v "Substantially lessen competition"

We note that your letter does not reply specifically to questions 1 and 2 of our letter of 4 July, in which we sought to establish why (a) the Administration had chosen the formulation "prevent, restrict or distort" competition (the "PRDC test") as opposed to the formulation "substantially lessen competition" (the "SLC" test) it had originally proposed in its May 2008 Consultation Paper, and (b) the Administration believes the PRDC test "reflects the international best practices".

Your letter essentially reiterates what the Administration has said to the Bills Committee, namely that in practice "the proposed conduct rules are similar to those in overseas jurisdictions" as well as in the Telecommunications Ordinance and Broadcasting Ordinance. But, with respect, this comment overlooks the fact that (as pointed out in our letter of 4 July) the European courts have interpreted the PRDC test in a very different way from that in which the SLC test has been interpreted. Whereas the European courts have interpreted PRDC in terms of a restriction on a business's commercial freedom (a very wide test), the SLC test looks at whether the conduct reduces substantially the intensity of market competition (as measured typically by higher prices, lower quality etc.) – a completely different and much narrower test. We believe that the latter test reflects more closely the policy objective the Government set out in its May 2008 consultation paper, and so the question remains as to why the Administration has decided to change from the SLC test to the PRDC test.

The risk of course is that if EU case law is to be used as guidance, the Hong Kong tribunal and courts will adopt the much wider approach under the PRDC test, which would be contrary to the Government's stated policy objective, and result in a very wide range of commercial agreements and conduct falling within the scope of the Conduct Rules, only a small proportion of which may cause any substantial harm to competition.

We do not wish to present in this letter a lengthy summary of the EU case law to demonstrate the significant difference between the PRDC test and the SLC test. But one case will perhaps provide a useful illustration. It is taken from the UK, which as you know closely follows the EU approach, and was the first ruling by the Competition Appeal Tribunal (CAT) under the UK Competition Act 1998. The case concerned one of the membership rules of the General Insurance Standards Council in the UK, which prohibited member insurance companies from dealing with brokers who were not also members. The CAT held that this restricted competition merely because it "limits the freedom of the insurer members of GISC to deal with whom they please. Freedom to compete implies the freedom to choose how, where, on what terms and with whom to do business". The effect this restriction might have had on the intensity of competition in the market was held to be irrelevant.[1]

The EU position has been further complicated by the fact that the EU Commission itself, in its enforcement practice, effectively uses the SLC test rather than the PRDC test, looking at the effects of the conduct on the intensity of competition in the market. The Commission therefore obviously takes the view that this approach represents current best practice. For example, in its enforcement guidelines on horizontal agreements it states: "For an agreement to have restrictive effects on competition within the meaning of Article 101(1) it must have, or be likely to have, *an appreciable adverse impact on at least one of the parameters of competition on the market, such as price, output, product quality, product variety or innovation.*" (emphasis added).[2] This statement, however, is not consistent with the European courts' case law, which prevails over the Commission's views in the event of conflict.

Your letter overlooks another important point. Called upon to interpret what PRDC means, a court will naturally observe that different formulations have been used under both the Merger Rule (SLC) and the Telecommunications and Broadcasting Ordinances. Logically, it would be right for the court to conclude from this that the legislature intended PRDC to mean something distinct from those other formulations, otherwise, it would have chosen one of them. This adds to the likelihood that the courts will interpret the PRDC concept in a manner which is inconsistent with the Government's policy objective, and which will result in an excessively wide range of commercial agreements and conduct falling within the scope of the Conduct Rules.

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[1] Cases 1002/1/01-1004/1/01 *Institute of Independent Insurance Brokers v Director General of Fair Trading*, 17 September 2001 at paras 179-218.

[2] Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements OJ C 11, 14.1.2011, p. 1–72 at para 27.

As you will appreciate, there is a substantial body of case law in Common Law jurisdictions which considers and provides clarity on the SLC test. There is, therefore, no need to try to use a less optimal formulation from the EU, particularly given the lack of clarity in the EU case law on the PRDC test.

"Object" or Effect" v. "Purpose or Effect"

Another difference between the Bill and the May 2008 Consultation Paper is the choice in the Bill of the term "object or effect" (again drawn from EU competition law) as opposed to "purpose or effect" as originally proposed. This is important, because the Administration's "guidelines" on the First Conduct Rule (CR1 guidelines) state that "object" does not mean the subjective intention of the parties- but it is not clear what "object" does mean. The CR1 guidelines state that "object" refers to "the objective purpose of the agreement considered in the economic context in which it is to be applied", but this test is not only obscure and susceptible to varying interpretations, it is also inconsistent with recent EU case law, which is itself unclear, as pointed out in the Table attached to our letter of 4 July. EU case law is inevitably complicated by the EU's single market and industrial policy, which are issues that bear no relevance to Hong Kong. We believe it is wrong to import consciously into Hong Kong, and encourage businesses and the courts to refer to, EU case law which is notoriously obscure, unclear and necessarily unsuited to Hong Kong, as a substitute for clear terminology in the Bill itself. (The same comment could be made about the use of the word "abuse" in the Second Conduct Rule – again a concept which experts agree is unclear and has never been satisfactorily defined under EU law). The UK's competition law has necessarily also been complicated by the requirement that it follows the EU system. Hong Kong should be recognizing these issues. Other Common Law jurisdictions (which have more relevance to Hong Kong than the EU) have used a "purpose and effect" test. This test has also been subject to legal debate but is to be preferred to the "object or effect" language of the EU. However, ultimately, the Chamber would encourage the Administration to move to a much clearer "effect or likely effect" test, which we believe will avoid many of the pitfalls of other jurisdictions in this area and be more easily understood by the courts in Hong Kong.

Question 3 of our letter therefore also remains unanswered, i.e. what is the basis for the Administration's implicit view that EU case law provides greater legal certainty than, say, the laws of Common Law jurisdictions such as Canada, Australia or New Zealand. We have noted above the significant distortion of EU competition law and cases arising from the multiple objectives of competition law enforcement and the EU's single market and industrial policy (including a heavy focus on liberalizing economies that have previously had high levels of government intervention and control). The EU system has, in short, been designed for an economic and political environment that bears very few similarities to Hong Kong's small, open and dynamic economy.

Automatic (or *per se*) breaches

In our letter of 4 July, we pointed out the ambiguity in the Administration's position regarding bid-rigging. We would hope you would agree that the statements in the CRI guidelines that bid-rigging, market-sharing and price-fixing "will, by [their] very nature, be

regarded as restricting competition appreciably", sound very much like an automatic, *per se* prohibition, i.e. a prohibition merely by virtue of the fact that the conduct has taken place, irrespective of any consideration of their actual effects in a particular case. We welcome your clarification that this is not the case. However, while we believe that each agreement or conduct should be looked at in the circumstances of a particular case to see if it has the effect of substantially lessening competition, we do not believe that any reference to "object" or "purpose" is appropriate, for the reasons given above. This is particularly the case since some of the EU cases suggest that certain types of conduct such as price-fixing, bid-rigging are deemed to have the "object" of restricting competition, which effectively means that they are automatically (or *per se*) prohibited:[3] according to your letter this would be contrary to the Government's policy objective. A far more appropriate formulation to address this limb of the Conduct Rules would be the "effect or likely effect" language proposed in the Chamber's November 2010 mark-up of the Conduct Rules.

Given that there are to be no automatic or *per se* breaches, we believe that this is a very important clarification which will have a substantial impact in practice, particularly for SMEs. We would therefore urge the Administration to clarify this point immediately and to issue revised versions of its "guidelines" documents as soon as possible, to include this clarification, and take into account other comments submitted during the consultation process on these documents, including those contained in HKGCC's submission of 11 July 2011 (available on Legco's website).

The Chamber's proposed enforcement mechanism for non-hardcore conduct

Your letter gives no adequate response to the Chamber's proposal for dealing with non-hardcore conduct, i.e. conduct other than price-fixing, market-sharing and bid-rigging. As HKGCC has previously made clear, its only reason for referring to Canada was to re-assure the Administration and Legco (if such re-assurance were needed) that in adopting HKGCC's recommended approach to non-hardcore conduct, Hong Kong would not be alone, and that there is a precedent for such an approach in Canada. Indeed, the Canadian approach just codifies in a clear way the reality of international competition law enforcement: a focus on hardcore conduct. Regulators and expert commentators around the world have recognized the difficulty regulating other conduct while trying to ensure the law does not over-reach and inadvertently suppress healthy and desirable competition. Hong Kong has had a long tradition of being cautious not to over-regulate its markets (recognizing the cost of excessive regulation to the economy and society) and the need to adequately address this issue in Hong Kong's law is therefore a very important policy issue.

We entirely disagree with the suggestion that this somehow means that, in going down this route, Hong Kong would have to adopt the Canadian competition law in its entirety: this is clearly not the case. Every jurisdiction needs to adopt competition policy and competition law that suit its political and economic environment. Nor do we agree with the implicit suggestion in your letter that Hong Kong has to observe Canada's experience with the recent extension of this approach to non-hardcore agreements before going down this route

[3] See the discussion in R. Whish *Competition Law* 6 ed at 116 to 122.

(incidentally Canada has been adopting this approach to non-hardcore unilateral conduct – which would be governed by the Second Conduct Rule – since 1979, so the approach is not as novel as your letter suggests). We fail to see why Hong Kong has to wait and observe developments in Canada before adopting this approach – the proposal is not only straightforward as a concept, it would also be straightforward in terms of understanding, education, clarity and enforcement. It would also be straightforward in drafting amendments to the Bill, as we have previously pointed out. Moreover, the Bill has been innovative (ie, mixing and matching aspects from other regimes or being new) in several other aspects such as the concept of infringement notices, and the penalty cap which is considerably higher than other jurisdictions.

So that there is no misunderstanding about the Chamber's proposal, and the reasons why it is the only fair, reasonable and economically sensible solution for dealing with non-hardcore conduct in Hong Kong, we attach a paper setting out the full details of the proposal, containing an explanation as to why it is more suitable than the approach under the Bill, as well as a letter which the Chamber has recently sent to the Bills Committee on this subject (dated 8 July).

We believe that, in effectively addressing the fundamental problem of legal uncertainty, which is clearly businesses' biggest concern about the Bill, such an approach would be supported by a large proportion of the Hong Kong business community. It will also solve any need the Government may feel to have an effective means of intervention in cases (which we submit are likely to be rare) where non-hardcore conduct causes substantial harm to competition which is not outweighed by efficiencies. An important aspect of this approach is that it allows the Competition Commission to regulate all of the conduct which the Administration considers could potentially be of concern, but it does so in a way that gives necessary legal certainty and reduces so far as possible the potential for this law to stifle healthy competition. This increase in legal certainty would, we believe, go a long way to addressing concerns that have been voiced by many sectors of the community, including the SMEs. It is, therefore, difficult to see what reasons there could be for objecting to this proposal but if, for whatever reason, such an approach is not accepted, the only fair and reasonable approach is for the Conduct Rules to be limited to dealing with only hardcore conduct.

We would be happy to elaborate on any of the points referred to above or provide any further clarification you may wish.

Sincerely

Alex Fong
CEO

HKGCC's proposed Enforcement Mechanism for "Non-hardcore" conduct: Why it is a fairer and economically more effective solution than the Bill's approach

Introduction: rationale for HKGCC's Proposal

The Bill proposes that the general prohibitions in the Conduct Rules should cover not only "hardcore" conduct, i.e. conduct which is normally regarded as being anti-competitive and generally suitable for prohibition (price-fixing, market-sharing, bid-rigging) but also normal commercial conduct ("non-hardcore" conduct) which, depending on the economic circumstances prevailing at the time, may be either economically efficient and good for consumers (which is usually the case), or (more rarely) economically inefficient and bad for consumers. Examples include joint purchasing, exclusive distribution, information exchange, tying and bundling.

HKGCC's contention is that this approach, imported from the EU, is not appropriate in today's environment, particularly in a jurisdiction like Hong Kong, and does not reflect current international best practice. Jurisdictions such as Canada and Australia have recently sought to draw a clearer demarcation line between these two categories of conduct – hardcore and non-hardcore – because of their fundamentally different nature. HKGCC believes that Hong Kong should do likewise, for two reasons:

- whereas hardcore conduct normally has no efficiency justification and is bad for consumers, non-hardcore conduct more often than not is efficient and good for consumers. To prohibit such conduct (or at least place on the parties the invidious burden of proving that the efficiencies outweigh the anti-competitive harm at any given point of time in future), as the current Bill would do, discourages legitimate competitive behaviour and therefore risks defeating the objective of the competition law;
- to prohibit conduct based on an assessment of whether, at any given point of time in future, it causes harm to competition which is "appreciable", and if so, whether there are economic efficiencies which outweigh that anti-competitive harm, is to subject businesses to a law which is inherently subjective and unpredictable. Such a law is therefore unfair and contrary to the rule of law, as enshrined in Hong Kong's Basic Law. The EU courts themselves have recognized that the enforcement of EU competition law is subject to the rule of law principle as enshrined in the European Convention of Human Rights, including the principle of legal certainty.[1]

[1] See for example Case C-189/02 P *Dansk Rorindustrie v Commission* (28 June 2005) at paras 215-222; Case T-99/04 *AC Treuhand v Commission* (8 June 2008) at paras 112-150.

Against this background, some might suggest that a law which prohibits only hardcore conduct is appropriate. HKGCC, however, has gone further than this. It acknowledges that there may be circumstances, albeit rare, in which non-hardcore conduct results in substantial harm to competition which is not outweighed by efficiencies, and which the Government may wish to address. HKGCC has proposed an appropriate enforcement mechanism for dealing with this situation. The solution is not to prohibit such conduct in principle from the outset (for the two reasons mentioned above), but to prohibit it only if and when the Tribunal has ruled, after careful examination, that the conduct produces substantial harm to competition is not outweighed by its efficiencies. In practice, a business would be given the opportunity to amend or terminate the conduct before the matter reached the Tribunal. Penalties would apply if the conduct continued after the Tribunal had ordered the business to stop.

The key advantages of this approach over the current Bill is that businesses can get on with their- in all likelihood beneficial- commercial conduct without fear of being found, perhaps several years later, to have inadvertently broken the law, in the event that the Tribunal rules against the conduct, with the benefit of hindsight not available to the business at the time when it embarked upon the conduct. It therefore addresses effectively the defects of the current Bill of (a) deterring conduct which may actually be beneficial for the market and consumers, and (b) prohibiting conduct which the parties had no means of predicting at the time would be held illegal, contrary to the principle of legal certainty under the rule of law. At the same time, it meets the Government's objective of stopping conduct which is genuinely very likely to be harmful to the economy. In other words, it strikes the right balance between legal certainty and economic efficiency. There is a precedent for this approach to non-hardcore conduct under the Canadian Competition Act and the actual operation of other competition regimes.

We deal below with three potential questions which may be asked about HKGCC's proposed approach.

<u>Other Laws prohibit conduct from the outset and not from the date of a court's judgment : why should Competition Law be different?</u>

Prohibiting non-hardcore conduct is entirely different from other laws prohibiting, say, theft or insider dealing. Conduct which constitutes theft is always theft and conduct which constitutes insider dealing is always insider dealing. However, non-hardcore conduct is, in the vast majority of cases, conduct which is pro-competitive and good for the economy. It is only in particular market circumstances (which may vary over time) that the conduct may become of concern to a competition regulator because it might impact on markets in a way that has undesirable consequences for the competitive process. Businesses are not in a position to predict in advance when those circumstances will arise. Unlike most other laws, therefore, it is impossible to define in advance what conduct will be prohibited and the

circumstances in which it will be prohibited. An upfront prohibition of conduct based on future perceived adverse economic effects (which is by definition a subjective assessment) is not, therefore, workable or just.

The key reason, therefore, that competition law is different is that, while other laws are able to define clearly in advance what conduct will be prohibited, competition law cannot, outside of hardcore conduct, give any degree of upfront clarity as to what conduct is and is not prohibited. We are aware of no other laws (apart from certain competition laws in other jurisdictions) which state that conduct will be illegal depending on its future effects on the market from time to time and whether any adverse effects of the conduct on competition from time to time are outweighed by efficiencies. The fact that some jurisdictions such as the EU may have laws of this kind due to their own particular historical and/or political circumstances does not mean they are acceptable in Hong Kong. In any event the EU (along with other developed competition law jurisdictions) itself has recognized the unacceptable legal uncertainty (and inevitable chilling effect on healthy competitive conduct) which laws of this nature bring and is looking at ways of resolving this problem- this makes it all the more unacceptable to import this uncertainty into Hong Kong. This is not unique to the EU. Jurisdictions the world over (including the US and now Canada) have also sought, in various ways and with varying degrees of effectiveness, to address this issue in their competition laws.

Formulating the prohibitions in simple terms makes this intuitively obvious. Compare "you shall not steal" or "you shall not deal in shares using inside information" with "you shall not enter into conduct which, at any given point in the future, produces appreciable adverse effects on competition which are not outweighed by the economic efficiencies produced by such conduct". The latter is literally, in essence, what a prohibition of non-hardcore conduct amounts to.

Analytically, what are the differences between prohibitions of theft and insider dealing (on the one hand) and non-hardcore conduct (on the other)?

- theft and insider dealing are relatively easy to define in advance, compared to the task businesses face in predicting whether at any given point in the future an agreement or course of conduct will be regarded as producing appreciable harm to competition which is not outweighed by efficiencies;
- even if there was scope for doubt as to whether a prospective course of action would amount to theft or insider dealing, society would suffer no loss if an individual refrained from engaging in the conduct on grounds of uncertainty as to whether it would break the law. By contrast, society stands to lose out substantially if businesses refrain from engaging in vigorous competitive behaviour for fear that it might be found to be anti-competitive: consumers would undoubtedly suffer.

It is therefore neither fair, nor economically sensible, to prohibit conduct in the non-hardcore category in advance, since (a) such conduct is more likely to be beneficial than not and (b) the circumstances in which it may be deemed not to be beneficial are in many cases impossible for businesses, and even the authorities, to predict in advance with sufficient certainty. A much fairer and economically more sensible solution is to allow the authorities to intervene if and when the circumstances justify it, i.e. in the rare circumstances when business conduct in the non-hardcore category produces a substantial lessening of competition which is not outweighed by efficiencies. This is what this Chamber is proposing.

There are numerous other legislative provisions which do not seek to prohibit certain acts or omissions in advance based on ill-defined criteria, but allow the authorities to intervene to change conduct if it is proving problematic for the economy or society. For example, sectoral economic regulation, such as that which exists in the telecommunications sector, allows the regulator to intervene in the market and require operators to take (or refrain from) certain actions based on certain telecommunications policy objectives, even although there was no pre-existing legal requirement to act in this way, subject to compliance with due process requirements. Indeed, this approach is more consistent with the principles of a free society like Hong Kong, where conduct is presumed to be legal unless there is a clearly-defined prohibition against it.

Could Businesses Profit from Anti-competitive Conduct until the Tribunal ordered them to stop?

The answer to this question is clearly no. As explained in detail in HKGCC's letter to the Bills Committee of 8 July (annexed for ease of reference) one of the reasons is that the Commission would have the same power as it would have in relation to hardcore conduct to apply to the Tribunal for an interim order to stop the conduct, pending a full investigation, where it was clear at an early stage that substantial harm to competition was likely and where such harm was unlikely to be outweighed by efficiencies.

Would the Law have sufficient deterrent effect if the Chamber's approach was adopted?

There are three answers to this question:

- The law should only seek to deter and penalize conduct which can be defined with a reasonable degree of precision, if it is to comply with the rule of law and in particular the principle of legal certainty. If the Government cannot define with sufficient precision the conditions under which a given type of conduct will be prohibited (as is clear from the Guidelines is the case with non-hardcore conduct) then it is unreasonable to expect businesses to do so, and to hold them in breach of the law if it is subsequently judged that their assessment was wrong.

- As noted in the introduction, a general prohibition of the type the Government is proposing is over-inclusive, and would deter conduct which is efficient and good for consumers, which would defeat the Bill's objectives. By contrast, HKGCC's approach would encourage businesses to get on with such conduct and bring benefits to consumers, while still enabling the authorities to intervene and stop non-hardcore conduct in the rare cases where it was causing substantial harm to competition which was not outweighed by efficiencies;
- in these latter cases, the parties in practice may well refrain from the conduct in any event, rather than incur the risk of being subject to complaints, investigation and possibly litigation, with the attendant costs and adverse publicity which that would involve.

Why the Government's proposals to address Legal Uncertainty do not work

HKGCC's proposal solves the problem of legal uncertainty, which is businesses' biggest concern about the Competition Bill, as was evident most recently from the strong views expressed at the public hearings held by the Bills Committee on 20 July. HKGCC here would note the very high percentage of businesses and jobs created and maintained by SMEs. The HKGCC approach solves the problem because it removes the need for businesses to seek specialist legal and economic advice on their proposed non-hardcore commercial arrangements and conduct, and to incur the costs which this entails, in order to minimize the risk of inadvertently breaching the law – because their conduct is not prohibited from day one, and is only prohibited if and when the Tribunal Orders it to stop (whether on an interim or a final basis). By contrast, the four ways in which the Government has sought to address legal certainty do not solve the problem, as explained below:

Guidelines. As many of those who spoke at the public hearings pointed out, the "guidelines" the Government has produced give no clear guidance on the circumstances in which a given type of conduct will breach the rules: in all cases the Government says that it depends on the facts of a particular case. For the same reason, future Commission guidelines are unlikely to give any clear guidance. Moreover Commission guidelines will not be binding on the Tribunal, so it is possible that the Tribunal will take a different view from the Commission. In the EU, for example, there are a number of cases where the European courts have disagreed with what the Commission has said in its guidelines. The guidelines will not even bind the Commission itself: experience shows that the enforcement authority will always leave itself room for manoeuvre in guidelines which it issues. For example, the TA's guidelines on the competition provisions of the

Telecommunications Ordinance state "nothing in the Guidelines would pre-empt the TA's subsequent consideration of particular events on their merits"[2].

Clearance decisions. The facility of applying to the Commission for a clearance decision will not work because (a) experience in the EU shows that general vaguely worded prohibitions of the type contained in the Bill will mean that the Commission will be inundated with applications: the process had to be abandoned in the EU for this reason in 2003. Indeed, the Government itself appears to have anticipated this problem by providing that the Commission will have no obligation to give a clearance decision, except in very limited circumstances. While this may save Commission resources, it will not help businesses seeking guidance on their proposed conduct; (b) the clearance only relates to whether an exclusion or exemption applies – not to whether it will be caught by the Conduct Rules in the first place, which is an equally difficult and complex assessment; (c) even if these problems could be resolved, in a free society like Hong Kong, it is unacceptable that virtually every commercial transaction, or at least most commercial transactions, need prior approval before they can be carried out, which would be the case in practice under the current Bill because of the wide and vague terms in which the prohibitions have been drafted.

Commitments. The Government has said that where there is no serious breach of the Conduct Rules and/or the parties have tried in good faith to comply with the law, the Commission might accept a commitment to cease the conduct instead of taking the case to the Tribunal. The problem with this proposal is that a commitment still implies that the business has broken the law, with the adverse legal and reputational effects which such a finding entails. So it does not help businesses ensure their conduct does not breach the law in the first place, and it also exposes the business to private damages claims.

Forbearance in penalties. Again, choosing to impose no penalty, or a nominal penalty, in non-serious or unintentional cases does not solve the problem that the parties have already broken the law, which can have serious adverse consequences (including private actions and brand damage) even if no penalty is imposed.

Conclusions

For all of the above reasons, the only solution to the legal uncertainty problem is not to prohibit non-hardcore conduct from the outset, because of the inherent unpredictability of such a prohibition and the danger of deterring efficient conduct which benefits consumers. At most, an enforcement mechanism of the kind HKGCC has proposed should be adopted to deal with non-hardcore conduct.

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[2] *Guidelines to Assist Licensees to Comply with the Competition Provisions under the Telecommunications Ordinance* (available at www.ofta.gov.hk) paragraph 1.3.