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Ms Anna Wu
Chairperson
Competition Commission
Room 3601, 3607-10, Wu Chung House
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Wanchai
Hong Kong

Dear Anna,

HKGCC: Response to Competition Commission's Consultation

HKGCC welcomes the opportunity to provide its comments on the Competition Commission's consultation document "Getting Prepared for the Full Implementation of the Competition Ordinance" ("the Consultation Document").

HKGCC appreciates that ultimately it will be for the Competition Tribunal and courts to interpret the Competition Ordinance ("the Ordinance"). However, it will be for the Commission to initiate proceedings before the Competition Tribunal, and the Commission will no doubt need to assess its enforcement priorities and block exemptions as contemplated by section 15 of the Ordinance. The Guidelines under the Ordinance could therefore provide very useful information on the types of cases which the Commission will choose to address, and the timescale for enforcement, so that businesses can prioritise their compliance efforts accordingly. Our submission makes five main points in this regard:

- The law must be implemented in a manner consistent with Hong Kong's economic policy.
- Consistent with this policy, vertical agreements should not be targeted under the First Conduct Rule and should be subject to a block exemption regulation, so that it is clear that they will be addressed only under the market power provisions of the Second Conduct Rule.
- The law does not provide for, and the guidelines should not therefore suggest, that there are any per se prohibitions or presumptions of anti-competitive conduct: the Commission should only tackle conduct which substantially lessens market competition without countervailing efficiencies.
- Efficient conduct should be permitted and encouraged.
- Business should be allowed a reasonable period after the Guidelines are finalized to make any necessary amendments to their agreements and conduct before the Conduct Rules take effect or before enforcement begins.

1. Implementation consistent with Hong Kong's economic policy

It is an important starting point in considering how to implement the Ordinance to appreciate that it does not seek to re-write Hong Kong's economic policy.

In this regard, Hong Kong has long recognized the risks of regulatory error when trying to second-guess the market and has had a presumption that markets get it right more often than regulators. In terms of competition policy, this is relevant in how the Commission should approach the question of Type I and Type II errors when determining its enforcement policy and the types of conduct that should be targeted under the law. In this context, it is useful to note a 2009 article in the Global Policy Review's Antitrust Chronicle (picking up on pronouncements of the United States enforcement agencies) that addresses the balance that is required:[1]

> *Recent pronouncements by the leaders of the federal antitrust agencies have brought into sharper focus the debate over how best to balance the risks of Type 1 error (or overenforcement error) against the risks of Type 2 error (or under-enforcement error) in antitrust enforcement. In this paper, we examine the literature surrounding the debate and suggest that the harm resulting from Type 1 error more likely and more often exceeds that stemming from Type 2 error. Indeed, the Supreme Court has recognized this imbalance in its antitrust jurisprudence, repeatedly insisting on rules that give more weight to avoiding over-deterrence of procompetitive conduct.*
>
> *Especially in the area of single-firm conduct analyzed under Section 2 of the Sherman Act or Section 5 of the FTC Act, the dangers of overly interventionist antitrust rules are not limited to actual government enforcement and private actions that lead to punishing and enjoining procompetitive conduct. Such rules create uncertainty and fear resulting in constructive Type 1 error; that is, businesses forego aggressive competition that benefits consumers for fear of becoming embroiled in government or private enforcement actions. These threats to consumer welfare are compounded by amorphous antitrust rules that make it impossible for businesses to know ex ante whether their conduct will be deemed violative of the antitrust laws. Such legal ambiguity can deter businesses from engaging in efficient, procompetitive conduct; even conduct that would ultimately be found to be legal.*

What this means in terms of general approach is that the Commission should not be seeking to 'cast the net too wide' (i.e. to over-apply the law or to refrain from applying appropriate exemptions and safe-harbours that would allow businesses more certainty as to what is prohibited) or to 'use a net that will catch minnows' (i.e. conduct that does not have the potential to substantially restrict competition). Ultimately, the law will stand the best prospect of maintaining and increasing competition in Hong Kong only if the balance is properly struck between Type I and Type II errors and businesses have as much clarity as possible on what is prohibited so that they can focus compliance efforts efficiently and effectively. This is all the more important for SMEs with limited resources for compliance, which comprise some 98% of the businesses in Hong Kong.

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[1] *'Type 1 Error and Uncertainty: Holding the Antitrust Pendulum Steady'*, published in Global Competition Policy: The Antitrust Chronicle, November 2009 (Vol. 1), written by James Rill & Thomas Dillickrath.

2. Vertical agreements are a market power related issue and should only be addressed under the Second Conduct Rule

It is generally recognised that vertical agreements only give rise to potential competition problems where there is substantial market power or dominance (on the supply or purchase side). Vertical agreements are therefore commonly excluded from overseas equivalents of the First Conduct Rule (such as in the EU and Singapore), and dealt with only where there is market power at a level that triggers concerns. In the EU, a block exemption (explained in more detail below) gives protection to vertical agreements under the EU equivalent of the First Conduct Rule. In Singapore, a statutory carve out mechanism is used to exclude verticals from Singapore's equivalent of the First Conduct Rule (with a power to bring specified issues back within the rule if circumstances warrant), making it clear that vertical agreements are generally to be addressed under Singapore's equivalent of the Second Conduct Rule.

It needs to be emphasised that the exclusion/exemption is not seeking to give undertakings a "get out of jail free" pass for vertical agreements. What it does, quite sensibly and consistent with economic analysis of when it is that vertical agreements might be of concern, is to ensure an appropriate exemption for agreements in circumstances where the involved undertakings do not have market power such that their vertical agreements could raise any legitimate competition concern.

It has been suggested by some commentators that because Hong Kong has not followed Singapore by introducing a "statutory carve out and claw back in" mechanism it was intended that verticals "would be in" the First Conduct Rule. However, it is respectfully submitted that this is not correct. Hong Kong has instead decided to use a block exemption mechanism.

There can be no doubt that the Administration intended that the block exemption mechanism in section 15 of the Ordinance would be applied to vertical agreements. This was clearly from, among other things, the draft guidelines tabled by the Administration during the Bills Committee stage, in which the Administration stated:

> *In respect of "vertical agreement", it is expected that the first conduct rule will be applied in a much more limited fashion. A vertical agreement is an agreement made by two or more undertakings, each operating (for the purposes of the agreement) at a different level of the production or distribution chain. For instance, where undertaking A produces raw material, and undertaking B uses raw material acquired from A as an input, A and B are in a vertical supply relationship. Generally, a vertical agreement should be viewed simply as a legitimate way of influencing how a supplier's product is distributed and marketed. A supplier competing with other suppliers generally has no incentive to use a distribution or marketing strategy that makes its product less attractive to consumers than its competitors' products. Restricting a supplier's vertical supply chain (restrictions on intra-brand competition) can have positive benefits for competition between different brands (inter-brand competition) by promoting inter-brand competition, for example, improved quality of service.*

In Hong Kong, there is even less need than other jurisdictions to apply the first Conduct Rule (or equivalents) to vertical agreements, because Hong Kong does not use a dominance test in the Second Conduct Rule. The Administration consciously chose to adopt what it considers to be a significantly lower threshold of "significant market power". The "significant market power" threshold under the Second Conduct Rule castes the net widely enough to catch any vertical agreements that might be of concern in Hong Kong.

Such an approach to vertical agreements would properly reflect Hong Kong's economic policy and reduce the chances of both actual and constructive Type I error, thereby ensuring the law does not unwittingly cause undertakings to refrain from pro-competitive distribution and other arrangements or put Hong Kong at a competitive disadvantage in the region. It would also ensure that businesses are not burdened with unnecessary compliance costs and ensure a law which is more cost effective for SMEs to comply with, without undermining in any way the objectives of the law.

It is important when considering the appropriate approach to vertical agreements to keep in mind that Hong Kong is a small, open economy (effectively just a city economy) with generally intense inter-brand competition and open borders, allowing both domestic and very large and well established overseas brands to compete vigorously in Hong Kong's markets. **There is no evidence of vertical agreements causing significant competition issues in Hong Kong absent market power.** Furthermore, the block exemption mechanism must be reviewed within a specified time (being no more than every 5 years). This means that a conservative approach which avoids the risk of Type I errors can (and should) be taken while Hong Kong finds its way with this complex new law while maintaining flexibility to adjust the approach going forward if circumstances require.

If a block exemption is not implemented in Hong Kong, this signals to the market that the Commission may target vertical agreements under both the First Conduct Rule and the Second Conduct Rule. This will create an extra layer of unnecessary regulation and potential "double jeopardy" for businesses. It will also significantly increase the risk of what is referred to in the GPR article cited above as "constructive Type I error", where businesses will refrain from implementing pro-competitive distribution and other strategies for fear of breaching an unclear rule. This would put the Hong Kong economy at a significant disadvantage against other economies in the region with which it competes, including Singapore. HKGCC believes that the Commission should introduce a block exemption regulation for vertical agreements at the earliest possible opportunity once the law takes effect. In the meantime the Guidelines should make it clear that vertical agreements will normally only be addressed under the Second Conduct Rule.

If the Commission is of the view that there needs to be an industry consultation before the finer points of the expected block exemption can be determined, then the HKGCC would suggest that the appropriate way of dealing with this in the guidelines is to make it clear that the Commission will not be initiating enforcement actions against vertical agreements pending the block exemption consultation. To do otherwise leaves businesses in the invidious position of potentially being forced (if taking a counsel of prudence) to unwind pro-competitive distribution and other vertical arrangements pending clarification from the Commission. There is no

rational reason to take a course that could have such a negative impact on the competitiveness of Hong Kong.

HKGCC does not believe that there are grounds for a different approach in relation to resale price maintenance ("RPM"), which has been highlighted in the Consultation Document. The same logic applies to this form of vertical restraint. Given the intense inter-brand competition in Hong Kong, RPM should be included within the block exemption, to make it clear that the focus of enforcement will be on RPM where there is significant market power. Again, the counsel of prudence would be for a block exemption to be issued in the early stages of implementation in Hong Kong – i.e. a phased approach, reviewing the situation when the block exemption is put to consultation and when reviewed in the next 5 years, rather than casting the net too wide and risking Type I error at the outset. If the Commission believes that RPM could cause competition problems even in the absence of substantial market power, then RPM could be excluded from the benefit of the block exemption, and continue to be subject to the First Conduct Rule and assessed on a case-by-case basis. However, the rationale for such an approach would need to be made clear and there is certainly no case for a **per se** prohibition of RPM – or indeed any other conduct – in Hong Kong, as submitted below.

Finally, given the intense inter-brand competition in Hong Kong and the Administration's stated view on vertical agreements (set out above), the guidelines should make it clear that vertical agreements will not generally be regarded as giving rise to "serious anticompetitive conduct". The only possible exception to this is where a vertical arrangement is effectively being used as a device or a cloak to give effect to horizontal concerted conduct of the sort that would be regarded as "serious anticompetitive conduct'.

3. No *per se* prohibitions – the Commission should only target conduct which substantially lessens market competition

Under both the First and Second Conduct Rules, unlike in some jurisdictions such as Australia and Canada, there are no per se prohibitions of specific types of conduct – all conduct is subject to the test of whether it has the object or effect of preventing, restricting or distorting competition. Nor is there any justification for presuming that certain specific types of conduct will always automatically have this object or effect.

For example, an agreement between two stall traders to refrain from competing with each other so that they can compete more effectively with a nearby supermarket may actually have a positive effect on market competition – and even if it did not, it would certainly not substantially decrease market competition. Regrettably, some confusion on this point seems to have arisen from the concept in the Ordinance of "serious anti-competitive conduct". As the slides accompanying the Consultation Document make clear, the only relevance of "serious anti-competitive conduct" under the Ordinance is that it does not qualify for the de minimis exception of HK$250 million, or the "warning notice" procedure. It is not automatically prohibited, and is still subject to the competition test, as the slides also indicate. We submit that the Guideline on the First Conduct Rule should make this point clear, for the avoidance of doubt.

Similarly, conduct engaged in by an undertaking with significant market power should not be presumed in any particular circumstances to be anticompetitive. The line between aggressive, but healthy and pro-competitive competition, on the one hand, and conduct that comprises an abuse of market power that substantially restricts competition, on the other, is a notoriously difficult line to draw (as is recognized in numerous judicial and regulatory decisions on unilateral conduct around the world). Where the conduct of an undertaking with significant market power is brought into question by the Commission, it is essential that there is rigorous assessment of the competition impact of such conduct and any related efficiencies, to ensure that the law does not, unwittingly, prohibit pro-competitive conduct simply because a company may have a strong market position.

4. Efficient Conduct should be permitted

Schedule 1 paragraph 1 exempts from the First Conduct Rule agreements which lead to overall economic efficiency, even though they may reduce competition. This reflects the total welfare standard (as opposed to the consumer welfare standard) which is applied in other relatively small, open economies such as Canada, Australia, New Zealand and Singapore. (The fact that a reference to "consumer benefit" was inserted in Schedule 1 paragraph 1 towards the end of the legislative process does not transform the test into a consumer welfare test: the efficiencies referred to in this paragraph can normally be assumed to benefit consumers). It would be helpful if the Commission made clear in its Guidelines that agreements which have efficiencies outweighing the reduction on competition will not be targeted.

Likewise, for consistency, the Guidelines should make it clear that under the Second Conduct Rule, conduct which excludes competition merely because of superior efficiency or performance will not be targeted (following the approach adopted in other major jurisdictions). It cannot have been the legislature's intention that efficiency enhancing conduct would be prohibited simply because those efficiencies are being implemented by a firm that has a strong market position.

5. Transitional Period

The Guidelines have always been regarded as essential in helping businesses comply with the Ordinance, given the relatively vague nature of the Conduct Rules. It is therefore also essential, as well as fair, to allow businesses a reasonable period after the Guidelines have been issued to study the Guidelines and make any changes to their agreements and practices before the Conduct Rules take effect or are enforced. HKGCC submits that a period of at least nine months would be fair and reasonable for this purpose.

6. Other Comments

In relation to the conducts listed in the Discussion Document appended to the Consultation Document, we would make the following observations:

- Given that there will be no warning notice for "serious anticompetitive conduct" it is important for the Commission to give very clear and comprehensive particulars in the guidelines as to what conducts will be regarded as "serious anticompetitive conduct".

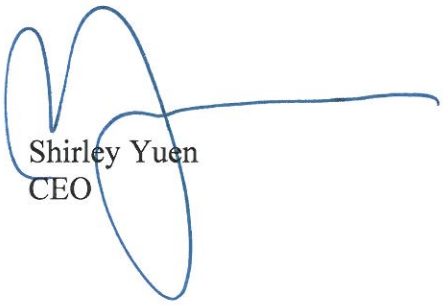
- We would submit that the guidelines should also make it clear that the focus of enforcement will be on serious anticompetitive conduct.

- The conducts listed as potentially being in breach of the Second Conduct Rule include a reference to the "essential facilities doctrine". The Commission will be aware that this purported doctrine, while having been applied in some more interventionist jurisdictions, such as the EU and Australia (which has a statutory regime) remains highly controversial in international competition policy debate and has never been recognised by the US Supreme Court. The existing sectoral competition law in Hong Kong (as implemented by the Telecommunications Ordinance (Cap. 106) contains an express statutory regime for granting access to essential facilities which was introduced because the legislature considered it a potentially necessary power for the regulator to have in the early stages of telecommunications sector liberalisation in Hong Kong. Absent an express and clear statutory intention to introduce such a regime under the Competition Ordinance, we would respectfully submit that the legislature did not intend to introduce this highly controversial doctrine into Hong Kong.

- In relation to the Merger Rule, the guidelines should make it clear that the merger carve-out applies both to the conduct/agreements that implement the merger and also to ancillary restraints, i.e. agreements directly related and necessary to the implementation of the merger.

I hope you will find our comments useful.

Yours sincerely,



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