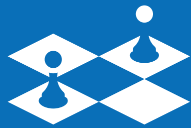

Draft Guideline on

The First Conduct Rule – 2014

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Guideline on the First Conduct Rule

*This Guideline is jointly issued by the Competition Commission (the "**Commission**") and the Communications Authority (the "**CA**") under section 35(1)(a) of the Competition Ordinance (Cap 619) (the "**Ordinance**").*

The Guideline sets out how the Commission intends to interpret and give effect to the First Conduct Rule in the Ordinance. The Guideline is not, however, a substitute for the Ordinance. The Competition Tribunal and other courts are responsible ultimately for interpreting the Ordinance. The Commission's interpretation of the Ordinance does not bind them.

This Guideline provides general guidance on the application of the First Conduct Rule and does not address all possible situations in which that rule might apply. Each case will be assessed on its own facts. The examples given in this Guideline are illustrative only.

The Guideline will be applied having regard to changes in market circumstances and prevailing case law. This Guideline may be amended from time to time in light of the experience of the Commission and the case law of the courts.

While the Commission is the principal competition authority responsible for enforcing the Ordinance, it has concurrent jurisdiction with the CA in respect of the anti-competitive conduct of certain undertakings operating in the telecommunications and broadcasting sectors.[1] Unless stated otherwise, so far as a matter relates to conduct falling within this concurrent jurisdiction, references in this Guideline to the Commission are to be read as applying also to the CA.

[1] The relevant undertakings are specified in section 159(1) of the Ordinance. These are licensees under the Telecommunications Ordinance (Cap 106) (the "**TO**") or the Broadcasting Ordinance (Cap 562) (the "**BO**"); persons who, although not such licensees, are persons whose activities require them to be licensed under the TO or the BO; or persons who have been exempted from the TO or from specified provisions of the TO pursuant to section 39 of the TO.

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1 The First Conduct Rule

1.1 Consumers (including businesses acting as customers)[2] benefit from competitive rivalry in the marketplace. Hong Kong's free market economy depends on a healthy competitive environment which incentivises businesses to offer better quality products, a wider variety of products, improved service and lower prices generally.

1.2 Most agreements and arrangements between market participants benefit consumers and the wider economy. Cooperation between businesses often stimulates more efficient, cost-effective and innovative business practices.

1.3 However, the benefits of a competitive market are undermined when market participants collude with competitors on key parameters of competition such as price, output, product[3] quality, product variety and innovation.

1.4 The proposition that competitors or potential competitors should make decisions on competitive parameters independently is embodied in the First Conduct Rule set out in section 6(1) of the Ordinance: "*An undertaking must not (a) make or give effect to an agreement; (b) engage in a concerted practice; or (c) as a member of an association of undertakings, make or give effect to a decision of the association, if the object or effect of the agreement, concerted practice or decision is to prevent, restrict or distort competition in Hong Kong.*"

1.5 The First Conduct Rule applies, however, not only to agreements and arrangements involving businesses which compete with one another. The rule also applies in respect of agreements and arrangements between parties who are not competitors to the extent that the relevant agreements and arrangements have the object or effect of harming competition[4] in Hong Kong.

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[2] References to consumers in this Guideline includes businesses acting as customers unless the context otherwise dictates.
[3] References to products in this Guideline includes services unless the context otherwise dictates.
[4] This Guideline uses the formulation "harm competition" as a convenient shorthand for "prevents, restricts or distorts competition".

1.6 The First Conduct Rule applies where there is an "agreement" or "concerted practice". These terms are explained in Part 2 of this Guideline. As a general proposition, there must be some conduct involving two or more parties. The First Conduct Rule captures contractual conduct but a contract is not a prerequisite. The rule may also apply where cooperation is non-binding or not legally enforceable.

1.7 The First Conduct Rule applies to "undertakings". The term "undertaking" is defined in section 2(1) of the Ordinance. An undertaking means any entity, regardless of its legal status or the way in which it is financed, engaged in economic activity, and includes a natural person engaged in economic activity. The term undertaking is therefore a broader concept than the term "company" as defined in section 2(1) of the Companies Ordinance (Cap 622) although a company may be an undertaking. An undertaking may also be an individual or a group of companies to the extent that the latter constitute an economic unit. The term undertaking is explained in further detail in Part 2 of this Guideline.

1.8 The First Conduct Rule also applies to "decisions" of an association of undertakings. The rule provides that undertakings are prohibited from making or giving effect to a decision of such an association, if the object or effect of the decision is to harm competition in Hong Kong. A trade association is an example of an association of undertakings and members of trade associations are therefore prohibited from making or giving effect to trade association decisions which harm competition.

1.9 The Ordinance recognises, however, that agreements[5] between undertakings, even where they harm competition, might nonetheless generate efficiency gains which may compensate for the harm to competition. In this context, section 1 of Schedule 1 to the Ordinance provides that the First Conduct Rule does not apply to an agreement which enhances overall economic efficiency. The general exclusion for agreements enhancing overall economic efficiency is outlined in Part 5 of this Guideline. The Annex to this Guideline contains a more detailed discussion.

1.10 The Ordinance also excludes certain conduct engaged in by small and medium sized enterprises from the purview of the Ordinance. Section 5 of Schedule 1 to the Ordinance therefore contains a general exclusion for agreements of lesser significance. The general exclusion for agreements of lesser significance is introduced in Part 5 of this Guideline. Further detail is available in the Annex.

[5] Generally, the term "agreement" when used in this Guideline is to be read as also encompassing a concerted practice and a decision of an association of undertakings.

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1.11 The Ordinance provides for certain other exclusions and exemptions with respect to the application of the First Conduct Rule. Details of these exclusions and exemptions are set out in the Annex to this Guideline.

1.12 The application of the First Conduct Rule as described in this Guideline is without prejudice to the possible parallel application of the Second Conduct Rule to the same conduct. Conduct which takes the form of, for example, an agreement might also infringe the Second Conduct Rule where the agreement incorporates terms amounting to an abuse of a substantial degree of market power.[6]

1.13 The First Conduct Rule applies to conduct which causes harm to competition *in Hong Kong*. Section 8 of the Ordinance provides that the rule applies even if the impugned conduct occurs outside of Hong Kong or any party to the conduct is outside Hong Kong.

1.14 The guidance in this Guideline provides a framework for the Commission's analysis of conduct falling within scope of the First Conduct Rule. This Guideline may therefore assist undertakings in determining whether or not their commercial arrangements and conduct comply with the First Conduct Rule.

2 Terms Used in the First Conduct Rule

2.1 This part of the Guideline provides an overview of how the Commission intends to interpret and apply certain key terms used in the First Conduct Rule and in the Ordinance generally.

Undertaking

2.2 The First Conduct Rule applies to "undertakings". The term "undertaking" is defined in section 2(1) of the Ordinance and refers to any entity (including a natural person), regardless of its legal status or the way in which it is financed, which is engaged in an economic activity. Examples of undertakings include individual companies, groups of companies, partnerships, individuals operating as sole traders, co-operatives, societies, business chambers, trade associations and non-profit organisations. The key question is whether the relevant entity is engaged in an economic activity.

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[6] See the *Guideline on the Second Conduct Rule* for guidance on how the Commission expects to interpret and give effect to the Second Conduct Rule set out in section 21(1) of the Ordinance.

2.3 The term "economic activity", while not defined in the Ordinance, is generally understood to refer to any activity consisting in offering goods or services in a market regardless of whether the activity is intended to earn a profit.

Single economic unit

2.4 The First Conduct Rule does not apply to conduct involving two or more entities if the relevant entities are part of the same undertaking. The question then is when will two (or more) entities be considered a single undertaking for the purposes of the First Conduct Rule. In this context, the approach of the Commission will be to assess whether the relevant entities constitute a "single economic unit" and therefore a single undertaking for the purposes of the First Conduct Rule.

2.5 When determining whether two or more entities should be considered a single economic unit, the Commission is not limited to the notion of a corporate or a company "group" within the meaning of the Companies Ordinance or other laws.

2.6 Whether or not separate entities form a single economic unit will depend on the facts of the case. However, generally, if entity A exercises *decisive influence* over the commercial policy of another entity B, whether through legal or de facto control, then A and B will be considered a single economic unit, and thus part of the same undertaking.

2.7 In particular, an agreement between a parent company and its subsidiary, or between two companies under the control of a third, will not be subject to the First Conduct Rule if the relevant controlling companies exercise decisive influence over their respective subsidiaries and notwithstanding that these various entities might have separate legal personalities.

Agents and distributors

2.8 Businesses often choose to distribute their products through third parties, such as agents[7] or distributors. Depending on the specific facts, the relevant business entities may or may not form part of the same economic unit as their agents or distributors. Labels such as "agency" or "independent distributor" used to describe a third party in this context are not determinative for the purposes of the Ordinance as to whether the "agent" or "independent distributor" is or is not a separate undertaking.

[7] An agent is a legal or physical person vested with the power to negotiate and/or conclude contracts on behalf of another undertaking (the principal) for the purchase of products by the principal or the sale of products supplied by the principal.

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2.9 Whether an "agent" is considered a separate undertaking depends upon the economic reality of the "agency" agreement. The determining factor for identifying a genuine agency agreement is the level of financial or commercial risk borne by the agent in relation to the activities for which it has been appointed as an agent by the principal.

2.10 For the purposes of the First Conduct Rule, the Commission will consider that an entity is a genuine agent, and therefore part of the same undertaking as the principal, if it does not bear any or bears only insignificant risks in relation to the contract concluded and/or negotiated on behalf of the principal. The greater the commercial risk taken by an agent, the more likely the agent will be considered a separate undertaking for the purposes of the First Conduct Rule.

2.11 Therefore, agreements between principals and their agents may or may not fall within the First Conduct Rule depending on the facts of the case. Agreements between undertakings and third parties which are not genuine agents fall within the First Conduct Rule.

Hypothetical Example 1

A manufacturer of hi-fi equipment sells its products to Hong Kong consumers directly through its website and through a number of retail stores. The retail stores are owned by separate legal entities who are party to a contract with the manufacturer which is entitled "Agency Agreement". The retail store owners are referred to throughout the Agency Agreement as the manufacturer's "agents". The Agency Agreement provides that the retailers must sell the products at a specified price not less than the manufacturer's current online price. While property in the contract products does not vest in the retailers at the time when the contract products are delivered by the manufacturer to the retailers, the Agency Agreement nonetheless provides that each retailer must:

(a) cover the cost of certain advertising related to the sale of the contract products;
(b) offer delivery and installation services in respect of the contract products with the costs of these services not being recoverable from the manufacturer;

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(c) accept responsibility for product liability risks toward customers and the risk of any failure by customers to fully pay for the contract products;

(d) accept the risk of unsold stock and returns; and

(e) bear the risk of stock shrinkage due to theft and/or in-store damage.

Given the level of risk assumed by the retailers, they would likely be considered separate undertakings in business on their own account. This is irrespective of the title of the agreement. The "Agency Agreement" would therefore be subject to the First Conduct Rule.[8]

Agreement

2.12 The term agreement is a broad concept which is defined in section 2(1) of the Ordinance to include any agreement, arrangement, understanding, promise or undertaking, whether express or implied, written or oral, and whether or not enforceable or intended to be enforceable by legal proceedings.

2.13 In determining whether there is an agreement, the Commission will seek to determine whether there is a "meeting of minds" between the parties concerned. Thus, an agreement under the First Conduct Rule may exist whether or not there has been a physical meeting of the parties. An agreement may be formed through, for example, an exchange of letters, emails, SMS, instant messages or telephone calls.

2.14 An undertaking may be found to be party to an agreement or, in the alternative, a "concerted practice" (see below) if it attended a meeting at which an anti-competitive agreement is reached and it failed to sufficiently object to, and publically distance itself from, the agreement or the discussions leading to the agreement, regardless of whether it played an active part in the meeting or intended subsequently to implement the agreement.

[8] The resale pricing clause in the hypothetical example is a form of "resale price maintenance". Resale price maintenance is discussed in Part 6 of this Guideline.

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Concerted practice

2.15 Not all anti-competitive conduct takes the form of an agreement. Instead, parties might adopt a looser type of cooperation termed a "concerted practice". A concerted practice is a form of cooperation, falling short of an agreement, where undertakings knowingly substitute practical cooperation for the risks of competition. Inherent in the concept is the notion that undertakings must determine independently the policies which they intend to adopt in the market and in particular their policies as regards price, product quality and other competitive parameters.

2.16 Undertakings are free to adapt themselves intelligently to the existing or anticipated conduct of competitors. Undertakings are, however, precluded from direct or indirect contact with competitors, where the object or effect of that contact is to create conditions of competition which do not correspond to the normal competitive conditions of the market in question (i.e. the competitive conditions that would pertain absent the contact).

2.17 More specifically, undertakings are precluded from any direct or indirect contact with other undertakings, where the object or effect of that contact is to influence the conduct on the market of an actual or potential competitor, or to disclose to such a competitor the course of conduct which they have decided to adopt or contemplate adopting in the market.

2.18 Parallel behaviour by competitors in the market (for example where their prices are similar) does not mean that the competitors are involved in a "concerted practice" or have made an agreement. If a market is highly competitive, it is to be expected that competitors will respond almost immediately to each other's pricing in the market. For example, if one competitor lowers its price, others are likely to respond to avoid losing customers. This behaviour is the very essence of competition and does not constitute a concerted practice.

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Hypothetical Example 2

Each calendar quarter, a number of private language schools in Hong Kong complete a survey, organised by one of the schools, which requests the schools to provide detailed information on their intended fee increases for the following quarter. The results of the survey are then distributed to each school that participated in the survey in advance of the schools finalising their respective fee arrangements for the next quarter. The results of the survey show the proposed future fees for all participating schools by name.

Assuming there is no evidence of an agreement, the Commission would consider the language schools' behaviour as, at least, a concerted practice. In a competitive market, each language school would be expected to make its fee decisions independently. This would result in a range of fee levels at the different schools, and a variety of options for students in terms of price. The exchange of sensitive price information has the effect of removing all uncertainty between the schools as to their respective fee-setting policies. The conduct harms competition and leads to higher prices.

Hypothetical Example 3

A highly specialised and niche insurance product was launched into the market with only three providers in Hong Kong. The product is sold to consumers via independent brokers. The sales directors of the three insurance providers recently attended a corporate golf tournament. During the tournament, the directors mentioned the commission rate that they currently offer brokers and one director commented that he was planning to lower his company's commission rate to a particular level. The information exchanged by the directors is confidential in nature. In the month following the golf tournament, each of the three insurers dropped the level of broker commission offered by their respective companies to identical levels.

The Commission would view the information exchange on intended commission levels as at least a concerted practice between the three insurance providers. On the facts, it will be assumed that the insurers took account of the information when determining their future commission levels. The fact that the parties exchanged information on only one occasion, and even assuming there was no agreement to lower commission as such, would not affect the analysis.

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Decision by an association of undertakings

2.19 The term "association of undertakings" is a broad concept and is not confined to entities holding themselves out as responsible for representing and/or defending the common interests of a group of undertakings – although such entities would typically be associations of undertakings in any event.

2.20 While the reference to "association" in the First Conduct Rule is not limited to any particular kind of association, examples of associations of undertakings include trade associations, cooperatives, disciplinary bodies, professional associations, societies and regulatory bodies, associations without legal personality, associations of associations etc.

2.21 The Commission considers a "decision" of an association of undertakings to include, without limitation:

(a) the constitution, guidelines, or rules of the association;
(b) resolutions, rulings or binding decisions of the management committee of the association, of the membership of the association or of the chief executive of the association; and
(c) non-binding recommendations of the association or any of its committees.

2.22 Importantly, a decision of an association may fall within the First Conduct Rule even if the decision is not binding on the association's members and even if the association's members have not, strictly speaking, complied with the decision.

2.23 In general, a non-binding recommendation of a trade association will amount to a decision for the purposes of the First Conduct Rule where it reflects the association's objective intention to coordinate the conduct of association members in the market in accordance with the terms of the recommendation.

2.24 Non-binding fee scales and reference sales and/or purchasing prices of trade and professional associations are examples of decisions of associations of undertakings.

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Hypothetical Example 4

At the annual meeting of an association representing mooncake bakers, the association's executive proposed a non-binding resolution that encouraged members to introduce a price increase of $10 on all mooncakes in time for the Mid-Autumn Festival. The resolution was passed unanimously. The stated aim of the resolution was to support the association members' position in the market as manufacturers of a "premium" and "niche" product and to protect members' profit margins. Association members generally implemented the price increase.

The resolution of the association would be viewed by the Commission as, at least, a decision of an association of undertakings. Although the resolution was non-binding and some members did not comply with it, the resolution is evidence of a common intention to raise prices to the detriment of consumers.

2.25 It will be a question of fact in each case whether an association of undertakings is itself a party to an agreement. In addition, an association of undertakings might amount to an undertaking in its own right and attract liability on that basis.

3 Object or Effect of Harming Competition

3.1 The First Conduct Rule only applies where the *object or effect* of an agreement is to harm competition in Hong Kong. The First Conduct Rule does not therefore capture all agreements. Most agreements between undertakings are unlikely to be anti-competitive and will not raise concerns under the First Conduct Rule.

3.2 The Commission interprets the First Conduct Rule to require that the Commission must demonstrate that an agreement has either an anti-competitive object or an anti-competitive effect. The anti-competitive object or anti-competitive effect of an agreement are therefore two alternative ways of showing that the agreement harms competition. Where an agreement has an anti-competitive object, it is not necessary for the Commission to also demonstrate that the agreement has an anti-competitive effect.

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3.3 When demonstrating that an agreement has an anti-competitive effect, the Commission will consider not only any actual effects but also effects that are likely to flow from the agreement – i.e. potential effects.

The "object" of harming competition

3.4 Certain types of agreement between undertakings can be regarded, by their very nature, to be so harmful to the proper functioning of normal competition in the market, that there is no need to examine their effects. Agreements within this category are considered to have the "object" of harming competition.

3.5 In order to determine whether an agreement entails such a sufficient degree of harm to competition that it may be considered as having the object of harming competition, regard must be had to the content of its provisions, its objectives and the economic and legal context of which it forms a part. In this respect, it is necessary to take into consideration the nature of the products affected, as well as the real conditions of the functioning and structure of the market in question.

3.6 The object of an agreement refers to the aims pursued by the agreement in light of its legal and economic context and the way it is implemented, and not merely the subjective intentions of the parties to the arrangement. Nonetheless, there is nothing to prevent the Commission from taking the parties' intention into account when determining whether or not an agreement has the object of harming competition.

3.7 The category of agreements which have the object of harming competition is an open one. Agreements between competitors to fix prices, to share markets, to restrict output or to rig bids are typical examples of agreements which are considered to have the object of harming competition. These agreements, often called "cartel" agreements, are universally condemned. In the case of vertical agreements between parties at different levels of the supply chain, resale price maintenance agreements are also considered by the Commission as having the object of harming competition.

3.8 Section 7(1) of the Ordinance provides that if an agreement has more than one object, it will be capable of breaching the First Conduct Rule if any one of its objects is to harm competition.

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3.9 Section 7(2) of the Ordinance provides that an anti-competitive object may be ascertained by inference. In practice, it will often be necessary to infer an anti-competitive object from the facts underlying the agreement and the specific circumstances in which it operates or will operate. These surrounding circumstances may indicate that the agreement has an anti-competitive object even though the formal agreement does not expressly say this.

3.10 An agreement may be considered to have an anti-competitive object, even if it is not implemented by the undertakings who are party to the agreement.

The "effect" of harming competition

3.11 If an agreement does not have an anti-competitive object, it may nevertheless infringe the First Conduct Rule if it has an anti-competitive effect. As noted above, the Commission interprets "effect" to include the actual or likely effects of the agreement.

3.12 For an agreement to have an anti-competitive effect on competition, it must have, or be likely to have, an adverse impact on one or more of the parameters of competition in the market, such as price, output, product quality, product variety or innovation. Agreements can have such an effect by reducing competition between the parties to the agreement, or by reducing competition between any one of them and third parties. Moreover, section 7(3) of the Ordinance provides that if an agreement has more than one effect, it is considered to have an anti-competitive effect if one of its effects is anti-competitive.

3.13 Anti-competitive effects on competition within a relevant market are likely to occur where it can be expected that, due to the agreement, the parties would be able profitably to raise prices or reduce output, product quality, product variety or innovation. This will depend on several factors such as the nature and content of the agreement, the extent to which the parties individually or jointly have or obtain some degree of market power, and the extent to which the agreement contributes to the creation, maintenance or strengthening of that market power or allows the parties to exploit market power.

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3.14 When assessing the actual or likely anti-competitive effects of an agreement, the Commission will consider the extent to which the undertakings concerned have market power in a "relevant market". The exercise of defining the relevant market assists in identifying in a systematic way the competitive constraints that undertakings face when operating in a market. The Commission's *Guideline on the Second Conduct Rule* sets out the Commission's approach to market definition and undertakings are referred to that Guideline for detailed guidance on the applicable principles.[9]

3.15 Market power can be thought of as the ability to profitably maintain prices above competitive levels for a period of time or to profitably maintain output in terms of product quantity, quality and variety or innovation below competitive levels for a period of time.

3.16 Market power is, however, a matter of degree. The degree of market power for concerns to arise under the First Conduct Rule is less than the degree of market power required for concerns to arise under the Second Conduct Rule which applies only when an undertaking has a *substantial degree* of market power in a market.

3.17 The assessment of market power of the parties to an agreement does not rely solely on any single factor and includes, for example, an assessment of the (combined) market shares of the parties, market concentration, barriers to entry or expansion in the market, the competitive advantages of the parties, and the existence of any countervailing power on the part of buyers/suppliers.[10]

3.18 In assessing whether conduct has the actual or likely effect of harming competition, the Commission may assess what the market conditions would have been in the absence of the conduct (known as the "counter-factual"), and compare these counter-factual market conditions with the conditions resulting where the conduct is present. In general, the Commission will consider the effects of specified conduct on a case-by-case basis in the light of available evidence.

[9] See Part 2 of the *Guideline on the Second Conduct Rule*.

[10] A detailed discussion of these various factors is contained in Part 3 of the Commission's *Guideline on the Second Conduct Rule*.

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Ancillary restrictions

3.19 If the main transaction covered by an agreement is not harmful to competition, it may become necessary to assess whether particular individual restrictions contained in the agreement are also compatible with the First Conduct Rule because they are "ancillary" to the main agreement. This principle may be particularly relevant, for example, in the context of an assessment of a distribution agreement or joint venture arrangement under the First Conduct Rule.

3.20 A restriction of competition will be ancillary when it is *directly related to and necessary* for the implementation of a separate, main (non-restrictive) agreement and *proportionate* to it. If the main parts of an agreement do not have the object or effect of harming competition, restrictions which are directly related to and necessary for implementing the main transaction will also fall outside the First Conduct Rule.

3.21 For an ancillary restriction to be considered "directly related to" a main agreement, the restriction must be subordinate to the implementation of the main agreement and be inseparably linked to it.

3.22 Ancillary restrictions must also be objectively "necessary" for the implementation of the main agreement and proportionate to it. If, without the restriction, the main non-restrictive agreement would be difficult or impossible to implement, the restriction might be regarded as objectively necessary and proportionate.

3.23 For example, in the case of a joint venture subject to the First Conduct Rule but which is not itself harmful to competition, a non-compete between the parent entities and the joint venture might be regarded as ancillary to the joint venture in certain circumstances.

4 Exclusions and Exemptions from the First Conduct Rule

4.1 Agreements that have the object or effect of harming competition may nonetheless generate pro-competitive benefits in the form of economic efficiencies. If an agreement is found to harm competition, the parties may therefore wish to provide evidence that the agreement entails such pro-competitive benefits. The Commission will consider this evidence and whether the alleged pro-competitive benefits compensate for the harmful impact of the agreement under section 1, Schedule 1 to the Ordinance – the general

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exclusion for agreements enhancing overall economic efficiency. The assessment of efficiencies therefore takes place under section 1 of Schedule 1 of the Ordinance and not under the First Conduct Rule as such.

4.2 The general exclusion for agreements enhancing overall economic efficiency applies automatically, and without any prior decision of the Commission, to all agreements that fulfil the cumulative conditions of the exclusion. In that regard, section 1 of Schedule 1 provides that the First Conduct Rule does not apply to any agreement that:

"*(a) contributes to–*
(i) improving production or distribution; or
(ii) promoting technical or economic progress,
while allowing consumers a fair share of the resulting benefit;
(b) does not impose on the undertakings concerned restrictions that are not indispensable to the attainment of the objectives stated in paragraph (a); and
(c) does not afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the goods or services in question."

4.3 The Commission interprets section 1, Schedule 1 to the Ordinance as a "defence" that can be invoked by undertakings in the context of an allegation that the First Conduct Rule has been infringed. The Commission is of the view that the burden of demonstrating that the terms of the general exclusion are met rests with the undertaking(s) seeking to rely on it.

4.4 Parties are free to argue that any restrictive agreement generates efficiencies, including agreements which have the object of harming competition. However, as a practical matter, conduct involving an agreement between competitors to fix prices, to share markets, to restrict output or to rig bids is unlikely to be justifiable on the basis of the general exclusion for agreements enhancing overall economic efficiency.

4.5 A more detailed discussion of the general exclusion for agreements enhancing overall economic efficiency is contained in the Annex to this Guideline. The Annex also includes discussion of other exclusions and exemptions from the First Conduct Rule including the general exclusion for agreements of lesser significance. This latter exclusion, which will be of particular relevance for small and medium sized enterprises, is also discussed briefly in Part 5 of this Guideline.

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4.6 Section 9 of the Ordinance permits undertakings to apply to the Commission for a decision that a particular agreement is excluded or exempt pursuant to the terms of the general exclusion for agreements enhancing overall economic efficiency and/or the various other exclusions and exemptions provided for in the Ordinance. The relevant procedures for making such an application are explained in the Commission's *Guideline on Applications for a Decision under Sections 9 and 24 (Exclusions and Exemptions) and Section 15 Block Exemption Orders*.

5 Serious Anti-competitive Conduct

5.1 Section 2(1) of the Ordinance defines Serious Anti-competitive Conduct to mean:

"*any conduct that consists of any of the following or any combination of the following –*

(a) fixing, maintaining, increasing or controlling the price for the supply of goods or services;

(b) allocating sales, territories, customers or markets for the production or supply of goods or services;

(c) fixing, maintaining, controlling, preventing, limiting or eliminating the production or supply of goods or services;

(d) bid-rigging."

5.2 The definition of Serious Anti-competitive Conduct is largely of procedural relevance. In that respect, there is no reference to the term in the First Conduct Rule or in Part 2 of the Ordinance generally. Ultimately, the test for determining whether an agreement falls within scope of the First Conduct Rule is whether the agreement has the object or effect of harming competition.

5.3 Nonetheless, once it has been determined that an agreement has the object or effect of harming competition and assuming there are no applicable exclusions or exemptions, it becomes relevant to consider whether the conduct amounts to Serious Anti-competitive Conduct as defined. In that regard, the implications of an agreement constituting or not constituting Serious Anti-competitive Conduct are the following:

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(a) Where conduct amounts to Serious Anti-competitive Conduct, the general exclusion for agreements of lesser significance contained in section 5, Schedule 1 to the Ordinance does not apply. Section 5, Schedule 1 excludes from the First Conduct Rule:

(i) agreements or concerted practices between undertakings in any calendar year if the combined turnover of the undertakings for the turnover period does not exceed HK$200 million; and

(ii) decisions of associations of undertakings in any calendar year if the turnover of the association for the turnover period does not exceed HK$200 million.[11]

(b) Where the Commission has reasonable cause to believe that a contravention of the First Conduct Rule has occurred and the contravention does *not* involve Serious Anti-competitive Conduct, the Commission *must*, before bringing proceedings in the Tribunal against the undertaking(s) whose conduct is alleged to constitute the contravention, issue a Warning Notice under section 82 of the Ordinance to the undertaking(s) concerned.[12] The Warning Notice procedure affords undertakings an opportunity to cease or alter the investigated conduct within a specified warning period. Where the Warning Notice procedure does not apply (i.e. in the case of Serious Anti-competitive Conduct), the Commission may institute proceedings directly before the Tribunal without any prior warning to the undertakings involved in the conduct.

5.4 The Commission takes the view that cartel arrangements between competitors (horizontal arrangements) that seek to fix prices, share markets, restrict output or rig bids[13] are forms of Serious Anti-competitive Conduct.

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[11] Turnover for the purposes of section 5, Schedule 1 includes turnover (total gross revenues) obtained both in and outside Hong Kong. In the case of an association of undertakings, turnover means the total gross revenues of all the members of the association whether obtained in Hong Kong or outside Hong Kong. Additional rules for the calculation of turnover under section 5, Schedule 1 will be provided in regulations made by the Secretary for Commerce and Economic Development. These regulations will be made available on the Commission's website.

[12] Under section 82(4)(b) of the Ordinance, the Warning Notice procedure does not apply where an undertaking repeats conduct in respect of which it has previously been issued a Warning Notice.

[13] For bid-rigging to amount to Serious Anti-competitive Conduct, the relevant conduct must also comply with the definition of bid rigging in section 2(2) of the Ordinance.

5.5 While the definition of Serious Anti-competitive Conduct does not preclude the possibility, vertical arrangements are generally not considered to be Serious Anti-competitive Conduct. Vertical arrangements, as compared with horizontal arrangements between competitors, are, as a general matter, less harmful to competition. Moreover, such arrangements may frequently generate efficiencies.

5.6 The Commission considers, however, that resale price maintenance may amount to Serious Anti-competitive Conduct in certain cases. The Commission considers resale price maintenance as having the object of harming competition.[14] The Commission notes that resale price maintenance is conduct falling within a literal reading of the definition of Serious Anti-competitive Conduct.[15]

5.7 Subject to the requirement that Serious Anti-competitive Conduct must accord with the terms of the definition in section 2(1) of the Ordinance, the category of Serious Anti-competitive Conduct is an open one.

5.8 It should be noted that whether conduct falls within the category of Serious Anti-competitive Conduct is a separate determination from whether the conduct has the object or effect of harming competition.

6 Agreements that May Infringe the First Conduct Rule

6.1 The First Conduct Rule applies to agreements to the extent that they have the object or effect of harming competition in Hong Kong. The First Conduct Rule applies to both horizontal agreements and vertical agreements. These terms are explained below.

6.2 A horizontal agreement is an agreement made by two (or more) actual or potential competitors, each operating at the same level of the production or distribution chain.

[14] See paragraph 3.7 of this Guideline. Further discussion of resale price maintenance is contained in Part 6 of this Guideline.

[15] Paragraph (a) of the definition of Serious Anti-competitive Conduct in section 2(1) of the Ordinance provides that conduct which consists of "*fixing, maintaining, increasing or controlling the price for the supply of goods or services*" is Serious Anti-competitive Conduct. Resale price maintenance involves the supplier fixing, maintaining or controlling the resale price for its products.

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6.3 Horizontal agreements may be particularly liable to harm competition and the First Conduct Rule seeks to prohibit horizontal agreements of this kind. By way of example, cartel arrangements negatively impact the market giving rise to higher prices, reduced output, reduced product quality, variety and innovation. The Commission has a strong interest in ensuring that such illegal practices are brought to an end and sanctioned proportionately.

6.4 However, it is recognised that certain horizontal agreements lead to economically beneficial outcomes, in particular, if they combine complementary activities, skills, or assets. Horizontal agreements of this kind can be a means of sharing risk, saving costs, increasing investments, pooling know-how, enhancing product quality and variety, and stimulating innovation. The First Conduct Rule is not intended to prohibit such agreements which either do not harm competition or which, even if they do harm competition, entail sufficient pro-competitive efficiencies and otherwise satisfy the terms of section 1, Schedule 1 to the Ordinance.

6.5 A vertical agreement is an agreement between undertakings who operate for the purposes of the agreement at a different level of the production or distribution chain. For instance, where undertaking A produces a raw material, and undertaking B uses that raw material acquired from A as an input in making B's own product, A and B are said to be in a vertical relationship.

6.6 While generally less harmful as compared with horizontal arrangements, some vertical agreements nonetheless contain provisions which have the object or effect of harming competition. This is particularly the case where these agreements include restrictions which foreclose existing competition or limit the scope for market entry or expansion. Moreover, in certain cases, vertical restrictions of competition may serve to facilitate horizontal coordination between competing suppliers and/or downstream distributors.

6.7 Nonetheless, vertical agreements very frequently improve economic efficiency within a chain of production or distribution by facilitating better coordination between the participating undertakings. In particular, such agreements can lead to a reduction in transaction and distribution costs and to an optimisation of the parties' sales and investment levels.

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6.8 The fact that vertical agreements are generally less harmful to competition while offering greater scope for efficiencies will be reflected in the Commission's approach to these arrangements. As a general matter, competition concerns will only arise where there is some degree of market power at either the level of the supplier, the buyer or at the level of both. Vertical agreements between small and medium sized enterprises would rarely be capable of harming competition. Moreover, such enterprises may be able to benefit from the general exclusion for agreements of lesser significance pursuant section 5 of Schedule 1 to the Ordinance.

6.9 In Figure 1 and the sections below, the Commission indicates its general scheme of analysis for typical types of agreements under the Ordinance. Figure 1 offers only a general categorisation and is subject to the detailed comments offered elsewhere in this Guideline.

Figure 1.

	EXAMPLES OF CONDUCT WHICH TYPICALLY HAVE THE OBJECT OF HARMING COMPETITION	EXAMPLES OF CONDUCT WHICH MAY HAVE THE EFFECT OF HARMING COMPETITION
Horizontal agreements	• *Price fixing* • *Market-sharing* • *Output restrictions* • *Bid-rigging* • *Exchange of future price and quantity information* • *Group boycotts*	• *Joint purchasing agreements* • *Exchange of information other than future price and quantity information* • *Standard terms and standardisation agreements* • *Membership and certification restrictions* • *Certain joint ventures*
Vertical agreements	• *Resale price maintenance*	• *Exclusive distribution or customer allocation agreements* • *Recommended and maximum resale price restrictions*

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Price Fixing

6.10 Agreements between competitors which fix, maintain, increase or otherwise control prices (generally termed price fixing) are examples of agreements with the object of harming competition.

6.11 Horizontal price fixing may take a number of forms. It may, for example, involve directly agreeing upon a specified price, the amount or percentage by which prices are to be increased or a price range. "Price" in this context includes any element of price and in particular includes any discount, rebate, allowance, price concession or other advantage in relation to the supply of products. An agreement with respect to a price element amounts to price fixing.

6.12 Price fixing can also be achieved by indirect means. Indirect price fixing includes where, for example, undertakings agree not to quote a price without consulting competitors, or not to charge less than any other price in the market. Similarly, the exchange of information on future price intentions will be assessed as price fixing.

6.13 An agreement concerning price may still amount to price fixing even if it does not entirely eliminate all price competition. Competition may, for example, be harmed despite the ability to grant discounts up to a certain agreed level on a published list price or notwithstanding that parties only fix one price component while competing on others.

6.14 Price fixing might also arise through the activities of a trade association or professional body. For example, members might be required to post their prices at the association's premises or on the association's website. Also, the association might issue a recommendation to members on prices and/or publish (possibly non-binding) fee scales for members. Where non-binding price recommendations or scale fees are intended to coordinate member pricing in the market, these arrangements will generally be assessed as having the object of harming competition, as ultimately the arrangements do not differ in substance to a direct agreement or concerted practice between the members of the association.

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Hypothetical Example 5

A number of new car dealers in Hong Kong meet to discuss how to avoid supposed consumer confusion on the range of car-financing options available in the market. The dealers agree to minimum interest rates on car finance packages. They also note that many dealers regularly offer heavy discounts from the list price prior to Chinese New Year. To prevent "too much" undercutting in the market, they agree to a discount of no more than 5% off the list price.

These agreements relating to the elements of price would be viewed by the Commission as having the object of harming competition. By collectively setting a minimum interest rate and fixing the maximum discount, key elements of price competition have been agreed by the competitors when these matters should be determined independently.

Market Sharing

6.15 Market sharing agreements are agreements between competitors that seek to allocate sales, territories, customers or markets for the production or supply of particular products. Market sharing entails competing undertakings agreeing to divide up a market so that the undertakings are "sheltered" from competition in their allotted portion of the market. For example, competitors might agree not to:

(a) compete in the production of certain products (undertaking A agrees it will only produce product X, while undertaking B agrees it will only produce product Y);
(b) sell in each other's agreed territories;
(c) sell to each other's customers (so-called "non-poaching" agreements); or
(d) expand into a market in which another party to the agreement is a potential rival – for example an agreement not to enter a particular geographical area or an agreement not to begin selling certain products.

6.16 Market sharing agreements have the object of harming competition. Even a "gentlemen's understanding" not to supply a competitor's existing customers, and/or to encourage such customers to stay with their existing supplier should the customer seek to switch supplier, are likely to be considered market sharing agreements with the object of harming competition.

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Hypothetical Example 6

A group of residential coach companies meet to discuss how they operate their services across Hong Kong. To enable them all to make what they consider to be a reasonable profit, they decide to allocate between themselves a number of routes based on the total projected number of passengers. They agree not to provide services or to pursue customers on routes which have been allocated to another company. They also agree not to launch new routes without consulting each other.

This agreement not to compete with one another in defined geographic areas has as its object the restriction of competition. The agreement removes from consumers a choice of supplier with the likely result of higher prices for the services concerned. Moreover, an agreement of this kind is unlikely to satisfy the conditions of section 1, Schedule 1 to the Ordinance. While the agreement may appear to have the merit of rationalising and avoiding overlapping services on the routes affected, it is unlikely that consumers would derive any benefit from an arrangement which seeks to eliminate all competition between the parties.

Output Limitation

6.17 Agreements between competitors which fix, maintain, control, prevent, limit or eliminate the production or supply of products are often referred to as "output limitation" agreements. Output limitation agreements can take the form of production or sales quota arrangements involving undertakings limiting the volume or type of products available in the market. Such agreements also include agreements that limit or coordinate investment plans or control capacity.

6.18 Output limitation agreements between competitors have the object of harming competition. Agreements which reduce or control the level of output of a product by their very nature result in price increases or other anti-competitive effects. Such arrangements may entail, for example, an alignment of product quality and/or facilitate other forms of collusion between suppliers – for instance on price.

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6.19 The fact that an industry might be perceived to be in "crisis" by industry participants as a result of structural over-capacity, is not a defence to an agreement on output limitation. So-called "crisis cartels" receive no special treatment under the Ordinance. Crisis cartels will be considered as having the object of harming competition.

Hypothetical Example 7

Local salted fish producers have faced financial difficulty for a number of years as supply in Hong Kong has increasingly outstripped demand. Given this "crisis" affecting the industry, the main producers meet to discuss how to restructure the sector with a view to rationalising what they consider to be a situation of "over-capacity". A scheme is agreed which encourages certain producers to withdraw from the production of salted fish for a period and to refocus their commercial activities on other areas of business. Those producers who continue to operate their salted fish businesses make certain compensation payments to the producers leaving the market and, as a further expression of solidarity, agree to cover the costs of decommissioning relevant production lines.

The Commission would view this scheme as having the object of harming competition. In a competitive market, the producers would be expected to make production and capacity decisions independently. It is not for the market participants in a particular market collectively to agree what the market outcome should be.

Bid-Rigging

6.20 Bidding or tendering procedures are often used in the marketplace and an essential feature of a competitive tender is that the potential suppliers prepare and submit bids independently.

6.21 Bid-rigging generally involves two or more undertakings agreeing that they will not compete with one another for particular projects but rather they decide among themselves which bidder will be the winner – the outcome of an ostensibly competitive process is therefore "rigged".

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6.22 Bid-rigging can take a number of forms. For example, the undertakings might agree that certain parties will not submit a bid or will withdraw a bid submitted previously. This is often called "bid suppression". Bid-rigging additionally covers situations where an agreement is made between the potential suppliers that:

(a) they will take *turns* at being the winning bidder. This is called "bid rotation";
(b) certain bidders will submit higher bid prices (or less attractive terms) than the supplier "chosen" to win the tender. This is known as "cover bidding"; or
(c) they will take other actions that reduce the competitive tension in the bidding process, such as by agreeing minimum bidding prices or agreeing that the winning bidder will reimburse other bidders' bid costs.

6.23 Bid-rigging might be thought of as a form of customer allocation. Bid-rigging has the object of harming competition and is a blatant infringement of the First Conduct Rule.

Hypothetical Example 8

A large company with a number of offices across Hong Kong decides to outsource its catering services. The company invites four competing caterers to bid for the new contract. The sales representatives of the four caterers meet, by chance, at a charity football match and discuss the tender. The sales representatives agree as follows: the first caterer will decline to submit a bid while the second will withdraw a previously-submitted bid; the third caterer will submit a higher priced "cover bid". The tendering company was not aware of these arrangements and proceeded to award the contract to the fourth caterer which, on the face of it, submitted the most "competitive" bid.

The Commission will consider this arrangement as having the object of harming competition. The caterers have sought to artificially pre-determine the outcome of the tender. In addition to reducing customer choice, the bid-rigging results in inflated prices for the outsourced catering services.

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Joint Buying

6.24 A joint buying (also known as group buying) agreement arises when undertakings agree to jointly purchase products (including in this context products used as inputs for the production of other products). Joint buying can be carried out in a number of ways, including through a jointly controlled legal entity, by an association of undertakings, by a contractual arrangement between undertakings, or some looser form of cooperation.

6.25 Joint buying can allow smaller undertakings to achieve purchasing efficiencies similar to their larger competitors. This may result in lower prices on the market where the joint buying takes place, lower transaction costs, and/or distribution efficiencies.

6.26 Joint buying should be distinguished from a buyers' cartel where parties collude on purchasing prices for purchases they will make *individually*. A buyer's cartel is a form of price fixing which has the object of harming competition.

6.27 Unless the arrangement serves as a disguised cartel, joint buying will be analysed with regard to its actual and likely effects on competition in its legal and economic context.

6.28 An analysis of the effects on competition of joint buying will consider the effects of the arrangement on both the upstream buying and the downstream selling markets, i.e. the relevant markets where the undertakings engage in the joint buying and the relevant markets where the jointly purchased products are subsequently sold or where other products produced using jointly purchased inputs are sold.

6.29 The possible anti-competitive effects of joint buying include higher prices, reduced output, product quality or variety, market allocation, or the anti-competitive foreclosure (exclusion) of purchasers who are not party to the joint buying. If downstream competitors purchase a significant amount of their products jointly in an upstream market, their incentives for price competition on the downstream market may be affected. If the undertakings have market power on the downstream markets, the lower prices achieved by the joint buying will not likely be passed on to consumers. If the joint buying group has market power on the upstream purchasing market ("buyer power"), there may be a risk that suppliers are forced to sell at prices which ultimately lead to reduced product quality, less innovation by suppliers and sub-optimal supply generally.

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6.30 Joint buying may also harm competition by facilitating downstream collusion between the parties to the joint buying. This may happen where the joint buying results in the undertakings achieving a high degree of commonality of costs or where the undertakings party to the joint buying share competitively sensitive information. The exchange of competitively sensitive information is discussed further below.

6.31 Agreements between competitors to purchase products jointly, so as to achieve efficiencies unavailable to the firms individually, generally will not be harmful to competition where the parties together do not have market power on either the upstream purchasing or the relevant downstream markets.

Hypothetical Example 9

With a view to achieving savings in their input costs, 100 small snack food retailers and market stall holders from across Hong Kong form a joint buying group. The buying group members are obliged to buy at least 50% of their snack food products through the buying group. Together, the small retailers account for a small portion of the relevant buying and selling markets in Hong Kong and there are a number of strong competitors in both buying and selling markets (including large wholesalers and supermarket chains).

The Commission would be unlikely to find that this arrangement has anti-competitive effects. Even if the formation of the buying group enhances the commonality of input costs across the small retailers to an extent, their market position on both the buying and selling markets and the presence of large competitors suggests harm to competition is unlikely. Furthermore, on the assumption that the joint buying agreement may give rise to harmful effects on competition, it is still likely to generate economic efficiencies in the form of economies of scale. As the buying group members face strong competitive pressures in the downstream selling market(s) from supermarket chains, it is likely that the cost savings achieved by the joint buying will be passed on to consumers. The general exclusion for agreements enhancing overall economic efficiency is therefore likely to apply.

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Exchange of Information

6.32 The exchange of information between undertakings may harm competition where it results in undertakings becoming aware of the market strategies of their competitors.

Information exchange facilitating cartel conduct

6.33 The exchange of information might be used to facilitate a cartel. This is particularly the case where the information exchange is intended to allow parties to a cartel to monitor whether other parties are complying with the cartel agreement. For example, where competitors have an agreement to share customer volume, they might regularly update each other on the numbers of customers purchasing their respective products.

6.34 The Commission will consider an information exchange of this kind as a constituent part of the cartel. The information exchange will be considered as having the object of harming competition.

Information exchange on future prices/quantities

6.35 When competitors share information on their future intentions with respect to price (or elements of price) or quantities,[16] the Commission will consider the information exchange as having the object of restricting competition.

Hypothetical Example 10

A trade association for junk owners collects from and circulates to its members information on their respective proposed future prices. This includes information as to the proposed prices for specific journeys. The information is not made available to the public and is circulated in advance of a seasonal price review by the association members.

The Commission would consider this arrangement as either an agreement or concerted practice with the object of harming competition. The information exchange allows the junk owners to adjust their future pricing to reflect the proposed pricing of competitors and thus reduces price competition in the market. The information exchange arrangement is an indirect form of price fixing.

[16] Including, for example, intended future sales, market shares, territories or sales to particular groups of customers.

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Information exchanged via customers and suppliers

6.36 The exchange of competitively sensitive information may not only occur directly between competitors or indirectly through a trade association. Instead, competitors may seek to use a third party supplier or distributor as a "conduit" for the indirect exchange of, for example, future pricing information. This may happen as the result of an agreement or there may simply be a concerted practice.

6.37 If undertakings exchange information on proposed future intentions with respect to price (for example, that they propose to comply with a particular recommended resale price) through a third party conduit (such as a common supplier), this will be considered a form of price fixing with the object of harming competition.

Other forms of information exchange

6.38 Other forms of information exchange, other than those discussed above, generally require a case by case assessment of their effects or likely effects on competition.

6.39 Whether or not these other forms of information exchange will have the effect of harming competition depends on the circumstances of the case including the characteristics of the market, the type of information exchanged and other relevant factors.

6.40 As a general matter, the smaller the number of undertakings operating in the market (i.e. the more "concentrated" the market), the more frequent the exchange of information between the undertakings concerned, the more competitively sensitive the information,[17] the more current it is, the more detailed the information exchanged, the more individualised or company specific the information, the more access to the information is limited to the undertakings participating in the information exchange (so that other competitors and consumers do not have access to it), the more likely it is that the information exchange will have the effect of harming competition.

[17] Competitively sensitive information includes information relating to price or elements of price, customers, production costs, quantities, turnover, sales, capacity, product quality, marketing plans, risks, investments, technologies and innovations.

6.41 The type of information exchanged and the structure of the market in which the information exchange occurs are important factors in the analysis. For example, the exchange of historical,[18] aggregated and anonymised data is less likely to harm competition, since the exchange of such information is unlikely to reduce independent decision-making by undertakings with regard to their actions in the market.

6.42 Additionally, in general, exchanges of *publicly available information* are unlikely to constitute an infringement of the First Conduct Rule. Publicly available information in this sense is information that is equally accessible in terms of the cost of access to all competitors and customers. Information which is more costly to obtain for parties not affiliated with the information exchange because they would need to gather and collate the information is unlikely to be considered truly public. Moreover, the fact that information could have been gathered from a customer does not mean that the information is publicly available.

6.43 Where information is exchanged *in public* so that all parties have access to the information (including consumers), harmful effects are less likely. Exchanges which take place in public are also more likely to generate efficiencies.

Hypothetical Example 11

There are five suppliers of pre-packaged fresh fruit to small grocery retailers in Hong Kong. Demand is unstable, varying with the season and the location of the grocery retailers. The suppliers frequently have significant volumes of unsold waste product. To address the problem, the suppliers hire an independent market research company to collate information on unsold fruit on a daily basis. Each week, the research company publishes on its website statistics for unsold fruit in an aggregated form broken down by district or location. The data allows the suppliers to better predict demand and assess their performance against that of the sector as a whole. The individual suppliers are unable to disaggregate the data to identify competitively sensitive information pertaining to any specific competitor.

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[18] Whether data is "historic" (in the sense that it is old enough not to pose any risk of harm to competition) depends on the specific characteristics of the market in question. There is no predetermined threshold in this respect.

The Commission is unlikely to consider that this information exchange has the effect of harming competition. The aggregated and arguably historic nature of the information exchanged, and the fact that the information is exchanged in public makes it less likely that harmful effects will arise. Moreover, the information exchange appears to give rise to efficiencies sufficient to satisfy the terms of section 1 of Schedule 1 to the Ordinance. In particular, the high levels of waste products suggest that the market is not working effectively. The information exchange seeks to correct this and does not in any event eliminate competition between the suppliers.

Group Boycotts

6.44 In most circumstances, an undertaking is free to choose with whom it will do business, and may refuse to do business with a specific undertaking.[19] However, an agreement or concerted practice amongst competitors not to do business with targeted individuals or undertakings may be an anti-competitive group boycott.

6.45 The Commission will consider that a group boycott has the object of harming competition when, in particular, a group of competitors agrees to exclude an actual or potential competitor.

6.46 Where a boycott is intended to facilitate a cartel agreement, the boycott will be considered as a constituent part of the cartel. Such a boycott has the object of harming competition. For example, the members of a price fixing cartel might agree actions intended to prevent market entry by new competitors or they might agree to take retaliatory measures against undertakings refusing to comply with the cartel agreement.

Hypothetical Example 12

Companies active in a particular heavy industry in Hong Kong rely on a variety of specialist recruitment agencies to source staff from overseas. HireMe Ltd recently entered the market with a new and innovative business model. HireMe acts as an intermediary consolidating the services of the different specialist agencies active in the supply of candidates to industrial clients. The HireMe business model aims

[19] Where an undertaking has a substantial degree of market power, a refusal to deal may, however, infringe the Second Conduct Rule. See the Commission's Guideline on the Second Conduct Rule for further detail in this respect.

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at giving its clients the option of a "one stop shop" so that they can avoid dealing directly with the different specialist agencies. HireMe aims to cater for the totality of its clients' hiring needs.

After HireMe entered the market, the major recruitment agencies in Hong Kong arrange a conference call to discuss the impact of HireMe and their shared concern that HireMe is causing instability in the market. During the call, the agencies agree to immediately terminate all existing contracts with HireMe and to refrain from entering into further contracts with the company. They undertake to ensure that their overseas branches do likewise. This agreement limits HireMe's ability to function as a "middle man" between the agencies and its customers.

The recruitment agencies' agreement is a targeted boycott of a competitor, aimed at excluding that competitor from the market. The Commission would consider the conduct as having object of harming competition. The boycott is unlikely to satisfy the terms of the general exclusion for agreements of overall economic efficiency in section 1 of Schedule 1 to the Ordinance.

Standard Terms and Standardisation Agreements

Standard terms

6.47 In certain industries market participants may agree on standard terms relating to the supply of products. The use of such terms is common, for example, in the insurance and banking sectors.

6.48 Often, the use of standard terms makes it easier for consumers to compare conditions offered and may therefore facilitate switching between alternative suppliers. Standard terms might also result in reduced transaction costs, facilitate market entry in certain cases, and increase legal certainty.

6.49 However, where standard terms define the nature of, or relate to the scope of, the product, their use may limit product variety and innovation. Similarly, standard terms relating to price can harm price competition. If a standard term becomes an accepted industry standard, restricting access to the standard term makes market entry more difficult.

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6.50 If a trade association prohibits new entrants from accessing its standard terms and the use of those terms is vital for successful entry into the market, the Commission will likely consider such conduct as having the object of harming competition. Standard terms affecting prices charged to consumers (including in this context terms which recommend particular prices) will also be considered as having the object of harming competition.

6.51 As a general rule, standard terms which do not affect price are unlikely to raise concerns under the First Conduct Rule if participation in the process for adopting the terms is *open*, the standard terms are *non-binding* and *accessible* to all market participants. However, this proposition may not apply in all cases including where the standard terms 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) as the use of such terms may entail a risk of reduced innovation and product variety. In this circumstance, a more careful assessment of the effects of the standard terms will be required.

Hypothetical Example 13

A trade association in the insurance sector circulates non-binding standard policy terms for pleasure boat insurance to members. The terms do not relate to the maximum extent of cover offered and do not concern premiums or other price elements. While a large number of insurers use the standard terms, contracts are nonetheless varied and tailored to individual client needs. The standard terms have the advantage, however, of allowing consumers to compare the various policies on offer in the market. The standard terms are accessible to all insurers on equal terms including potential new entrants.

These standard terms relate to the scope of the product sold to consumers and may therefore raise a concern under the First Conduct Rule. That said, harm to product variety, if any, appears limited as the affected insurance policies are still tailored to individual customer needs. Moreover, the standard terms entail efficiencies as they allow consumers to compare the various products on offer, facilitate switching between insurers and facilitate market entry. Competition is therefore enhanced by the standard terms. Overall, even if the adoption of the standard terms has a harmful effect on competition, there appears to be a plausible efficiency justification under section 1 of Schedule 1 to the Ordinance.

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Standardisation agreements

6.52 In some markets, businesses may make agreements on the definition of technical or quality requirements with which, for example, current or future products must comply. Such agreements often increase competition and lower production and sales costs, benefiting consumers and the economy as a whole. Standardisation generally promotes interoperability and enhances product quality.

6.53 However, agreements that use a "standard" as part of a broader restrictive agreement aimed at excluding actual or potential competitors may be considered by the Commission as having the object of restricting competition. Other forms of standardisation agreement generally require an analysis of their actual or likely effects on competition.

Terms of Membership of Trade Associations and Certification

Terms of membership of trade associations

6.54 Market participants in many sectors form associations to represent and further their collective interests. Such associations provide a range of helpful and legitimate services for their members.

6.55 Membership of an association can, however, in some cases be an essential pre-condition for competing in a market. In such circumstances, exclusion from membership can significantly impact an undertaking's effectiveness as a competitor and might be equivalent in terms of effect to an anti-competitive boycott.

6.56 To minimise possible competition concerns, the rules of admission to membership of an association should be transparent, proportionate, non-discriminatory, based on objective standards and provide for an appeal procedure in the event of a refusal to admit a party to membership. Rules of admission to membership which do not satisfy these requirements may be viewed by the Commission as having either the object or effect of harming competition.

6.57 Procedures for members wishing to leave an association (and/or join a competing association) or expelling the members of an association may harm competition, where they are not based on reasonable and objective standards or where there is no proper

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appeals procedure in the event of expulsion from membership. In this context, the effect of a restriction on leaving an association may prevent undertakings from developing alternative business opportunities thus harming the competitive process.

Certification

6.58 A trade association sometimes certifies, or awards quality labels to members to recognise that they have met certain minimum industry standards. Such practices are often valuable to consumers, for example, where they offer a quality assurance and may promote interoperability between products.

6.59 Where certification is available to all suppliers that meet objective and reasonable quality requirements, it is unlikely to raise concerns under the First Conduct Rule.

6.60 The Commission is more likely to consider certification practices as having the object or effect of harming competition when additional obligations are imposed on members as regards the products they can buy or sell (for example, an obligation only to sell the certified products) or where restrictions are imposed on members' pricing or marketing conduct.

Hypothetical Example 14

For many years a local professional body organised a certification scheme whereby members were able to advertise themselves as "endorsed" by the professional body. Consumers considered the existence (or absence) of such an endorsement as a key consideration in their choice of service provider. The professional body recently decided to change its membership requirements to include a minimum turnover threshold for members to remain eligible for membership. The new requirements were discussed at a meeting at which only a few (larger) members attended, and where concerns were expressed that certain smaller members were offering "low quality" quality services and engaging in "low pricing" conduct. As a result of the new requirements, a number of smaller members were no longer eligible for membership and began to lose a significant proportion of their existing customers as they could no longer claim to be "endorsed".

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The Commission is likely to have concerns under the First Conduct Rule in respect of this fact scenario. The change to the rules here is on its face discriminatory and seems intended to exclude smaller market participants from membership of the professional body with the result that they are placed at a competitive disadvantage. The rule change may force some of the smaller companies to cease trading altogether potentially allowing the larger competitors to raise their prices. It cannot be excluded that the Commission would consider the rule change as having the object of harming competition.

Resale Price Restrictions

Resale price maintenance

6.61 Resale price maintenance ("**RPM**"), a form of resale price restriction, occurs whenever a supplier establishes a fixed or minimum resale price to be observed by the buyer when it resells the product affected by the RPM obligation.

6.62 RPM can restrict competition in a number of ways:

(a) RPM facilitates coordination between competing suppliers through enhanced price transparency in the market;

(b) RPM undermines suppliers' incentives to lower prices to distributors[20] and distributors' incentives to negotiate lower wholesale prices;

(c) RPM limits "intra-brand" price competition by restricting the ability of distributors to offer lower sales prices for the affected brand as compared with prices offered by competing distributors of the same brand. This will be a concern in particular where there are strong or well organised distributors operating in a market. RPM facilitates coordination between buyers on the downstream market affected by the RPM. In this context, the Commission will have a particular concern where there is evidence that the RPM conduct is buyer driven;

(d) RPM prevents the emergence of new market participants at the buyer level and will generally hinder the expansion of distribution models based on low prices (for example, the emergence of discounter distributors); and

[20] While reference is made to distributors throughout the discussion of resale price restrictions, retail price restrictions can also be imposed on retailers selling to end-consumers. The principles discussed in paragraphs 6.61 to 6.75 apply equally in the case resale price restrictions imposed on retailers.

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(e) where RPM is implemented by a supplier with market power, this may have the effect of excluding smaller suppliers from the market. Distributors are incentivised to promote the product affected by the RPM causing harm to consumers.

6.63 RPM can be achieved indirectly by, for instance, fixing the distributor's margin or the maximum level of discount the distributor can grant from a prescribed price level. The supplier might also make the grant of rebates or the reimbursement of promotional costs subject to the observance of a given price level by the distributor, or link the prescribed resale price to the resale price of competitors. The supplier might equally use threats, intimidation, warnings, penalties, delays in or the outright suspension of deliveries to achieve RPM.

6.64 Where an agreement involves direct or indirect RPM, the Commission takes the view that the arrangement has the object of harming competition.

Hypothetical Example 15

NailCo, a manufacturer of nails and screws for DIY and construction purposes sells its products in Hong Kong through independent retail stores. NailCo requires each of the stores to sell its products at a price stipulated by NailCo. NailCo justifies its pricing policy as a means of ensuring an orderly market and to avoid customer confusion as a result of differing prices across Hong Kong. NailCo claims the arrangement affords retailers a healthy profit margin.

The Commission would view this arrangement as having the object of harming competition. NailCo's justifications for the RPM practice will not likely satisfy the terms of the general exclusion for agreements enhancing overall economic efficiency in section 1 of Schedule 1 to the Ordinance. NailCo's justifications appear merely to suggest that RPM is a good way of keeping prices high. The argument that RPM avoids confusing customers amounts to an assertion that price competition is harmful for consumers. Price is the key parameter of competition and price competition is central to the regime established by the Ordinance.

Recommended or maximum prices

6.65 Where a supplier merely *recommends* a resale price to a distributor or requires a reseller to respect a *maximum* resale price, the agreement will not be considered by the Commission to have the object of harming competition.

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6.66 Instead, an agreement which entails recommended or maximum resale prices will be subject to an analysis of its competitive effects.

6.67 Recommended or maximum resale price agreements may give rise to a concern where they serve to establish a "focal point" for distributor pricing (that is, where the distributors generally follow the recommended or maximum price), and/or where they soften competition between suppliers or otherwise facilitate coordination between suppliers. An important factor in the analysis is the market position of the supplier. The more the supplier has market power, the more likely it is that the conduct will have the effect of harming competition.

6.68 Recommended or maximum resale price arrangements, when they are combined with measures that make them work in reality as fixed or minimum prices, will be assessed in the same manner as RPM.

6.69 This could include, for example, the use of a price monitoring system, or an obligation on buyers to report other members of a distribution network that deviate from the recommended or maximum price level, as well as, measures which reduce the buyer's incentive to lower the resale price, such as the supplier printing a recommended resale price on the product.

6.70 Where a firm retaliates or threatens to retaliate when its "recommended" resale price is not followed, the Commission will consider the price is not truly recommended and assess the conduct as a form of RPM having the object of harming competition.

Efficiency justifications for resale price restrictions

6.71 Resale price restrictions, including RPM, may lead to efficiencies of the type detailed in section 1, Schedule 1 to the Ordinance. While efficiencies must be assessed on a case by case basis, examples of possible efficiencies which might flow from resale price restrictions in certain circumstances are given below.[21]

6.72 Where a supplier introduces a new product, RPM may help induce distributors to better take into account the supplier's interest in promoting the product during the introductory period of expanding demand. In this respect, RPM might incentivise increased sales or promotional efforts on the part of the distributors.

[21] The discussion here in respect of efficiencies is subject to the more detailed discussion in the Annex to this Guideline. Undertakings will be required to substantiate efficiencies and may not simply assert them. Moreover, undertakings seeking the benefit of the general exclusion for agreements enhancing overall economic efficiency will be required to demonstrate that all the conditions for the application of that exclusion have been met.

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6.73 RPM may be of assistance in a franchise or similar selective distribution system for the purposes of organising a coordinated price campaign of limited duration.

6.74 RPM may help address so-called "free rider" problems at the distributional level where the extra margin guaranteed by the RPM structure encourages parties to provide certain sales services for the benefit of consumers. This efficiency may have relevance in the case of "experience" or complex products.

6.75 In the case of maximum resale prices, the resale price restriction may help to ensure that the brand in question competes more effectively with other brands notably when it avoids "double marginalisation".[22]

Hypothetical Example 16

A well-known producer of confectionary products wishes to introduce a range of "K-Pop" candy products into Hong Kong which have been successful elsewhere in Asia. The producer's existing share of supply in Hong Kong is less than 5% and it is hoped the new product range will be its 'break' in terms of reaching Hong Kong consumers. The producer requires its retailers in Hong Kong to sell its product at HK$5 – which the producer understands to be a lower price than those of competing brands (which retail between HK$6 and HK$8.) To make a splash, the producer proposes to market the product across Hong Kong as "$5 a POP".

Such an agreement on fixing the resale price may raise concerns of having the object of harming competition. The agreement reduces the ability of independent retailers to set the price of the new products at a lower price or to set the price as they see fit.

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[22] Double-marginalisation occurs where the supplier and buyer both have market power and both apply a high margin when selling the product with the result that the end price is higher than the price that would have been charged by a vertically integrated monopolist. A maximum resale price may therefore have the effect of reducing the end price and increasing output.

However, even if the resale price does have an anti-competitive object, the parties may be able to bring forward evidence of economic efficiencies under section 1 of Schedule 1 to the Ordinance. In particular, given that the fixed resale price is for a short introductory period, it may be considered to be important to allow a new product to establish itself in the market. As such, the fixed price encourages retailers to stock the product, increase sales through promotional activities and thus expands overall demand and thereby improves distribution in the market with consumers likely to be afforded a fair share of these benefits. The absence of market power on the part of the supplier suggests that the practice is unlikely to eliminate competition in the relevant market. Consequently, the general exclusion for agreements enhancing overall economic efficiency appears likely to apply on the facts.

Exclusive Distribution or Exclusive Customer Allocation

6.76 In an exclusive distribution agreement, a supplier assigns exclusivity for the resale of its products in a particular territory to a single distributor (or reseller). In an exclusive customer allocation agreement, the supplier assigns exclusivity to a single distributor for resale to a particular group of customers. The possible risks to competition from such agreements are reduced competition between distributors for the same products/brands, potential market sharing, and a reduction in competition through limiting market access to potentially competing distributors.

6.77 Exclusive distribution and exclusive customer allocation agreements will not generally be considered by the Commission to have the object of harming competition. For the purposes of the First Conduct Rule, these types of agreement will generally require an analysis of their effects or likely effects on competition, including an assessment of how intra-brand and inter-brand competition[23] is affected, the extent of the territorial and/or customer sales limitations, and whether exclusive distributorships are common generally in the markets impacted by the agreements under consideration.

6.78 Exclusive distribution and exclusive customer allocation may, however, lead to economic efficiencies of the type required for the purposes of section 1 of Schedule 1 to the Ordinance. This may be the case, for example, where investments by distributors are required to protect or build up the brand image of a product or where specific

[23] Intra-brand competition is competition between products of the same brand. Inter-brand competition is competition between products of differing brands.

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equipment, skills or experience are required for a particular group of customers. Exclusivity provisions may incentivise distributors to invest in marketing and customer service – thereby making the concerned product more competitive as against other branded products in the market. This in turn ensures a wider range of product choices for final consumers. Exclusive distribution agreements may also lead to savings in logistics costs due to economies of scale in transport and distribution.

6.79 The level of trade affected by the exclusivity might also be relevant in this context. For example, a manufacturer might choose a particular wholesaler to be its exclusive distributor for the whole of Hong Kong. Assuming there are no resale restrictions on the wholesaler, the loss of intra-brand competition at the wholesale level might be justified by reference to efficiencies in terms of logistics considerations.

6.80 Generally, in the case of exclusive distribution and exclusive customer allocation, arguments raised and supported by evidence that the agreements in question entail economic efficiencies within the meaning of section 1 of Schedule 1 to the Ordinance will require careful consideration.

Hypothetical Example 17

SportCo, a global brand, is a medium-sized player in the Hong Kong market for sports equipment. SportCo's practice is to appoint an exclusive wholesale distributor for each country where its products are marketed and it has one such distributor for Hong Kong. To become a SportCo exclusive wholesaler, a distributor is obliged only to sell SportCo products and not to sell products from SportCo's competitors. Distributors are responsible for all promotional activities in their allotted territory.

While the combination of an exclusivity territory arrangement with a "non-compete" might give rise concerns under the First Conduct Rule in some cases in terms of foreclosing competing suppliers, there is no evidence on the facts that this would be a concern here. The restrictions placed on the distributor serve to incentivise the promotion of the SportCo brand and are likely justifiable under the general exclusion for agreements enhancing overall economic efficiency in section 1 of Schedule 1 to the Ordinance.

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Hypothetical Example 18

A manufacturer has developed a new pool cleaning device. Although the manufacturer is currently the leading supplier of pool cleaning technologies in Asia, its competitors are also set to launch new "ground-breaking" products. The installation requirements of the device differ depending on the size, type and frequency of use. For example a public swimming pool, a pool provided by a residential block of flats and a smaller single-family residential pool would each have different needs. The manufacturer appointed a small number of retailers in Hong Kong to sell and install the devices. Each retailer needs to properly train its employees to ensure the device is correctly installed for the specific customers' needs. To ensure retailers are willing to invest in such training, the manufacturer assigns to each retailer a specific class of customer and prohibits retailers from seeking customers of any other type.

The Commission would be more likely to raise concerns under the First Conduct Rule when such agreements prevent customers from having a choice between retailers for a product – and thus risk being charged higher prices. This is most likely when the manufacturer and/or the retailers have market power and there are limited alternative devices by other manufacturers for customers to choose from.

Even if the agreement did impact on competition, the Commission is likely to be attentive to potential economic efficiencies of the type listed in section 1, Schedule 1 to the Ordinance. For example, the agreements may improve distribution by helping to ensure that retailers recoup their sunk costs in training and product development – ensuring the new device has a route to market.

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Joint ventures

6.81 The term "joint venture" can be used to describe various types of cooperative arrangement between undertakings including, for example, joint production arrangements, joint buying arrangements, joint commercialisation arrangements, and joint R&D ventures. Joint ventures can involve the establishment of a legal entity or they might be achieved by mere contractual arrangements.

6.82 Where a joint venture amounts to a "merger" as defined in section 2(1) of the Ordinance, the joint venture is excluded from scope of the First Conduct Rule and the Second Conduct Rule (collectively the "**Conduct Rules**") as a result of section 4 of Schedule 1 to the Ordinance. In this context, section 2(1) provides that a merger has the meaning given by section 3 of Schedule 7 to the Ordinance read together with section 5 of Schedule 7. Specifically, in the context of a joint venture, section 3(4) of Schedule 7 provides that the creation of a joint venture "*to perform, on a lasting basis, all the functions of an autonomous economic entity*" constitutes a merger.[24]

6.83 Where a joint venture is not a merger as defined, the general exclusion for mergers in section 4 of Schedule 1 of the Ordinance ceases to apply and the joint venture comes within scope of the Conduct Rules. Therefore, joint ventures which do not perform, on a lasting basis, all the functions of an autonomous economic entity are within scope of the Conduct Rules.

6.84 The Commission considers the following non-exhaustive factors as providing an indication that a joint venture is within scope of the Conduct Rules generally and the First Conduct Rule specifically. Not all of these factors need be present in a given case.

(a) the joint venture does not have a management dedicated to its day-to-day operations or access to sufficient resources including finance, staff, and assets, in order to conduct on a lasting basis its business activities;
(b) the joint venture merely takes over a specific function within the parent companies' business activities. This would be the case with joint ventures limited to production or R&D or where the joint venture effectively acts as a distribution arm for the parent entities;
(c) the joint venture sells a significant proportion of its output to its parents; and/or
(d) the joint venture is created for a short finite period of time. For example, where a joint venture is established to construct a particular project such as a power plant but will not be involved in the operation of the plant beyond the construction phase.

[24] See generally the Commission's *Guideline on the Merger Rule* for more a detailed discussion of when a joint venture might amount to a merger within the meaning of the Ordinance.

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6.85 Where a joint venture falls within scope of First Conduct Rule, the Commission will consider whether the venture has the object or effect of harming competition in Hong Kong. The applicable principles in this respect are those explained generally in this Guideline and the fact that the parties might form a legal entity for the purposes of implementing their joint venture has no particular bearing on the analysis.

6.86 As explained in Part 3 of this Guideline, if the main parts of a joint venture agreement do not have the object or effect of harming competition, restrictions which are directly related to and necessary for implementing the joint venture will also fall outside the First Conduct Rule. For example, a non-compete between the parent entities and their joint venture might be regarded as directly related to and necessary for implementing the joint venture in certain circumstances.

Production joint ventures

6.87 A common form of joint venture that may fall within scope of the First Conduct Rule is a production joint venture. Joint production agreements take a number of forms. They may provide that production is carried out by one party or by two or more parties or the parties may establish a separate legal entity for the purposes of the joint production.

6.88 Generally, agreements which involve price-fixing or output limitation have the object of harming competition. In the case of joint production, the parties might well agree to a particular level of output for the joint venture. The Commission will not consider this sort of arrangement as having the object of harming competition but will consider more generally whether the production joint venture as a whole has the effect of harming competition.

6.89 Similarly, if the parties to a production joint venture agree that the joint venture will sell the jointly produced products, the joint setting of the price of those products will not be considered as having the object of harming competition where joint sales are necessary for joint production to be implemented in the first place (i.e. if absent the joint selling, the parents would not otherwise enter into the joint production). Again, in this circumstance the Commission will consider the actual or likely effects of the joint venture as a whole on competition.

6.90 Where a joint production agreement allows parties to produce a product that they would not, objectively, be able to produce alone, the agreement will not likely have the object or effect of harming competition.

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6.91 Joint production agreements may have the effect of harming competition, for example, where producing jointly leads to reduced product variety, where the joint venture charges a high transfer price to the parent entities leading to higher prices for customers of the parents, where producing jointly leads to an increase in the parties' commonality of costs or where the agreement leads to an exchange of competitively sensitive information.

Hypothetical Example 19

Two leading suppliers of an industrial chemical product in Hong Kong, Company A and Company B, decide to close their existing independent production facilities, and open a more efficient joint plant solely for use by A and B. Company A and B do not agree on any terms beyond those strictly limited to the running of the new facility. There are only two other competitors, C and D in the market who are running their plants at full capacity. Company B already has an existing joint venture with C. Costs of production are a significant proportion of the variable costs of the companies active in the market. The market has not seen any recent entry.

In assessing whether the creation of the joint production facility would give rise to concerns under the First Conduct Rule, the Commission would consider:

- the existing market structure and the state of competition in the market;
- whether the agreement enhances the commonality of costs as between Companies A and B; and
- whether competition (on price) would likely be "softened" in the market as a result of the joint venture.

6.92 Even where they have the effect of harming competition, the Commission recognises that many production joint ventures are likely to entail economic efficiencies sufficient to satisfy the terms of the exclusion for agreements enhancing overall economic efficiency set out in section 1 of Schedule 1 to the Ordinance. This might particularly be the case where the joint production results in significant cost savings and synergies and/or economies of scale or scope, or improvements in product range or quality.

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Annex
Exclusions and Exemptions from the First Conduct Rule

1 Introduction

1.1 The Ordinance provides for a number of exclusions and exemptions from the First Conduct Rule.

1.2 Undertakings to whom an exclusion or exemption applies will not contravene the First Conduct Rule even where their conduct has the object or effect of harming competition. There is no requirement for undertakings to apply to the Commission in order to secure the benefit of a particular exclusion or exemption. It is up to undertakings to assess for themselves whether their conduct complies with the First Conduct Rule. Equally, undertakings may assert the benefit of an exclusion or exemption as a "defence" in any proceedings before the Competition Tribunal or other courts.

1.3 However, the Ordinance provides that undertakings may elect to apply to the Commission under section 9 of the Ordinance for a decision pursuant to section 11 of the Ordinance as to whether or not their conduct is excluded or exempt from the First Conduct Rule. If an undertaking wishes to seek greater legal certainty, it may therefore apply to the Commission for a decision under section 11 of the Ordinance. The Commission is, however, not required to accept all applications for such a decision. It is entitled to exercise its discretion under the Ordinance on whether or not to accept an application.

1.4 The Commission's *Guideline on Applications for a Decision under sections 9 and 24 (Exclusions and Exemptions) and section 15 Block Exemption Orders* provides information on how undertakings can apply to the Commission for a decision on whether a statutory exclusion or exemption applies.

1.5 The First Conduct Rule does not apply where it is excluded by or as a result of the application of an exclusion in Schedule 1 to the Ordinance. In this respect, Schedule 1 to the Ordinance provides for the following general exclusions:

(a) agreements enhancing overall economic efficiency;
(b) compliance with legal requirements;

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(c) services of general economic interest;
(d) mergers; and
(e) agreements of lesser significance.

1.6 Discussion on each of these general exclusions and other statutory exclusions and exemptions is provided in the sections which follow.

2 Agreements Enhancing Overall Economic Efficiency

2.1 If an agreement has the object or effect of harming competition contrary to the terms of the First Conduct Rule, it becomes relevant to consider whether or not the agreement gives rise to economic efficiencies. Section 1, Schedule 1 to the Ordinance provides the framework for this assessment.

2.2 The application of the exclusion for agreements enhancing overall economic efficiency is subject to a number of cumulative conditions. All of these conditions must be satisfied before an agreement is shielded from application of the First Conduct Rule. In this respect, section 1 of Schedule 1 provides that the First Conduct Rule does not apply to any agreement that:

"*(a) contributes to–*
(i) improving production or distribution; or
(ii) promoting technical or economic progress,
while allowing consumers a fair share of the resulting benefit;
(b) does not impose on the undertakings concerned restrictions that are not indispensable to the attainment of the objectives stated in paragraph (a); and
(c) does not afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the goods or services in question."

2.3 The overall economic efficiency exclusion does not distinguish between agreements which have as their object harm to competition and agreements which have anti-competitive effects. Both categories of agreement can be assessed for efficiencies and both categories of agreement may be excluded from the application of the First Conduct Rule on that basis.

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2.4 Where an agreement is considered to have as its object or effect harm to competition contrary to the First Conduct Rule, the investigated parties may plead the exclusion for agreements enhancing overall economic efficiency as a "defence". The Commission is of the view that the burden of proving that each of the cumulative conditions of section 1 of Schedule 1 is satisfied rests with the undertaking(s) seeking the benefit of the general exclusion.

2.5 With a view to explaining how the Commission expects to interpret each of the cumulative conditions of section 1 of Schedule 1, these conditions are discussed in detail below.

First condition

The agreement contributes to improving production or distribution or promoting technical or economic progress

2.6 Application of the exclusion for agreements enhancing overall economic efficiency entails an assessment of the economic benefits generated by the claimed efficiencies having regard to the harm to competition. A first step in the analysis is therefore to ascertain the objective efficiency benefits created by the agreement and the economic importance of those efficiencies.

2.7 The term "efficiencies" refers to benefits from improving production or distribution or from promoting technical or economic progress.

2.8 The Commission considers that undertakings seeking to invoke the exclusion for agreements enhancing overall economic efficiency in respect of a particular agreement must show evidence of the following:

(a) the claimed efficiencies. These must be *objective* in nature. Efficiencies will not be assessed from the subjective point of view of the parties to the agreement;

(b) a direct causal link between the relevant agreement and the claimed efficiencies;

(c) the likelihood and magnitude of the claimed efficiencies. Efficiencies must be sufficient to compensate for the harm to competition associated with the agreement; and

(d) how the efficiencies will be achieved and when they will be achieved.

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2.9 Undertakings cannot simply assert the claimed efficiencies. They must be able to demonstrate on the basis of verifiable evidence the likelihood and magnitude of each claimed efficiency in addition to the other factors referenced above. As the efficiencies must compensate for the harm to competition associated with the agreement, evidence of substantial efficiency gains will need to be particularly strong where the undertakings involved in the agreement account for a substantial proportion of competition in the market.

2.10 The types of efficiencies mentioned in section 1, Schedule 1 ("*improving production or distribution*" and "*promoting technical or economic progress*") are broad categories covering all objective economic efficiencies. As a general matter, these efficiencies can be cost efficiencies or qualitative efficiencies.

2.11 Cost efficiencies (i.e. cost savings) can originate from a number of sources. The development of new production technologies, for example, may give rise to cost savings; so too may the synergies brought about by an integration of particular assets. Cost efficiencies may also result from economies of scale or scope (for example where producers of different products improve distribution by sharing distribution costs).

2.12 Qualitative efficiencies arise when agreements between undertakings generate efficiencies in the form of quality improvements, innovation, or similar product improvements. This type of efficiency can include the technical and technological advances brought about when undertakings cooperate on research and development leading to improved or new products.

2.13 Examples of improvements in production or distribution that the parties may wish to provide evidence for include lower costs from longer production or delivery runs, or from changes in the methods of production or distribution; improvements in product quality; or increases in the range of products produced.

2.14 Efficiencies resulting from the promotion of technical progress may include efficiency gains from economies of scale and increased effectiveness in research and development. These efficiencies may be categorised as cost efficiencies or qualitative efficiencies depending on the facts of the case.

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Second condition

Consumers receive a fair share of the efficiencies

2.15 Section 1 of Schedule 1 to the Ordinance requires that consumers receive a fair share of the efficiencies claimed by the parties and generated by the agreement. Consumers in this context means all direct and indirect purchasers of the relevant products including businesses acting as purchasers (e.g. manufacturers purchasing inputs, retailers etc) and final consumers.

2.16 Undertakings seeking to invoke the exclusion for agreements enhancing overall economic efficiency in respect of a particular agreement must therefore show evidence that consumers receive or will receive a fair share of the efficiencies generated by the agreement.

2.17 The Commission considers that the notion of a "fair share" means that the benefits accruing to consumers must at a minimum compensate them for the actual or likely harm to competition associated with the relevant restrictive agreement. While the parties need not demonstrate that consumers receive a share of every efficiency gain, the overall impact for consumers must at least be neutral and parties must demonstrate that this is the case. Moreover, what matters here is the overall impact on consumers of the products within the relevant market as a whole and not the impact on individual consumers or individual consumer groups within that market.

Third condition

The agreement does not impose on the undertakings concerned restrictions that are not indispensable to the attainment of the relevant efficiencies

2.18 The third condition requires that the agreement does not impose on the undertakings concerned restrictions that are not indispensable to the attainment of the relevant efficiencies. For the purposes of satisfying this test, the parties must demonstrate that the agreement itself, and each of the individual restrictions contained in the agreement, are reasonably necessary to attain the claimed efficiencies. The determinative factor in this context will be whether the restrictive agreement and the individual restrictions in it make it possible to perform the activity in question more efficiently than would likely have been the case in the absence of the agreement or the restrictions.

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2.19 This third condition implies that as regards the agreement there be no other economically practicable and less restrictive means of achieving the claimed efficiencies.[25] If the parties can show that the agreement is reasonably necessary to achieve the efficiencies in this sense, they must then demonstrate that the individual restrictions in the agreement are also reasonably necessary in order to produce the efficiencies. An individual restriction can be considered indispensable or reasonably necessary if its absence would eliminate or significantly reduce the relevant efficiencies or make it significantly less likely that they will materialise.

Hypothetical Example 20

DrinkCo is a producer of carbonated soft drinks, holding 60% of the market. The nearest competitor holds a 20% share. DrinkCo concludes supply agreements with customers accounting for 50% of demand in Hong Kong, whereby they undertake to purchase exclusively from DrinkCo for 7 years.

DrinkCo claims that the agreements allow it to predict demand more accurately and thus to better plan production, reducing raw material storage and warehousing costs and avoiding supply shortages.

Given the market position of DrinkCo and the coverage of the restrictive arrangements, the exclusive purchasing agreement seems unlikely to be considered indispensable. The exclusive purchasing obligation would therefore exceed what is reasonably necessary to plan production and/or achieve the other claimed efficiencies. The 7 year term is also not likely to be indispensable and/or the efficiencies generated are unlikely to compensate for the foreclosure effects of an exclusive purchase arrangement of that duration.

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Fourth condition

The agreement does not afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the goods or services in question

2.20 The fourth condition requires that the undertakings that are party to the relevant agreement demonstrate that their agreement does not afford them the possibility of eliminating competition in respect of a substantial part of the goods or services in

[25] The market conditions and business realties facing the parties should be taken into account in this context.

question. This condition recognises that protecting the competitive process takes priority over the potential efficiency gains which might result from a particular agreement – ultimately the competitive process is the best guarantor of efficiency in the longer term.

2.21 Whether there is a possibility of competition being eliminated depends on the reduction in competition that the agreement brings about and the state of competition in the market. The weaker the state of existing competition in the market, the smaller any further reduction in competition would need to be for competition to be eliminated. Similarly, the more the relevant agreement causes harm to competition, the greater the likelihood that the undertakings concerned are afforded the possibility of eliminating competition.

2.22 An evaluation of whether there is a possibility of competition being eliminated will therefore require consideration of the various sources of competition in the relevant market and the impact of the agreement on these various sources of competitive constraint. While sources of actual competition will generally be more important, potential competition should also be considered. In this context, the parties will need to do more than merely assert that barriers to entry are low.

2.23 The possibility of eliminating competition within the meaning of the fourth condition means the possibility of eliminating *effective* competition in respect of a substantial part of the goods or services in question. Further, where effective competition is at risk of elimination in respect of one of its most important expressions that will suffice for the purposes of showing that the parties have been afforded the possibility of eliminating competition within the meaning of the fourth condition. This will be particularly the case if the agreement affords the undertakings concerned the possibility of eliminating effective price competition in respect of a substantial part of the goods or services in question.

Hypothetical example 21

Airlines A and B, have together more than 70% of the passenger traffic on the route between destination X and Hong Kong. A and B conclude an agreement whereby they agree to coordinate their schedules and certain of their tariffs on the route in the context of a codeshare arrangement. Following the implementation of the

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agreement, prices rise by between 30% and 50% for the various fares on the route. There are three other airlines operating on the same route, the largest, a low cost carrier, has about 15% of the passenger traffic on the route. The other two carriers are niche operators. There has been no new entry in recent years and the parties to the agreement did not lose significant sales following the price increases. The existing competitors brought no significant new capacity to the route and no new entry occurred.

In light of the market position of the parties and the absence of competitive response to their joint conduct, it might reasonably be concluded that the parties to the agreement are not subject to any significant competitive pressures. Therefore, it is more likely that in such a market where competition is already weak, the relevant agreement may afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the services in question and therefore reliance on the efficiency exclusion is misplaced.

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3 Compliance with Legal Requirements

3.1 Section 2 of Schedule 1 to the Ordinance provides that agreements or conduct are excluded from the First Conduct Rule and Second Conduct Rule to the extent that the relevant agreement or conduct is made or engaged in for the purposes of complying with a legal requirement imposed by or under any enactment in force in Hong Kong[26] or imposed by any national law[27] applying in Hong Kong.

3.2 The Commission considers that for this general exclusion to apply, the relevant legal requirement must eliminate any margin of autonomy on the part of the undertakings concerned compelling them to enter into or engage in the agreement or conduct in question.

[26] Section 2, Schedule 1 to the Ordinance. An "enactment" is defined in section 3 of the Interpretation and General Clauses Ordinance (Cap 1) (the "**Interpretation Ordinance**") to mean any Ordinance, any subsidiary legislation made under any such Ordinance and any provision or provisions of any such Ordinance or subsidiary legislation.

[27] Section 3 of the Interpretation Ordinance provides that the term "national law" means a national law applying in Hong Kong pursuant to the provisions of Article 18 of the Basic Law.

3.3 Where an undertaking has some scope to exercise its independent judgment on whether it will enter into an agreement or engage in the relevant conduct, the general exclusion for complying with legal requirements will not be available. Accordingly, if the relevant agreement or conduct is merely facilitated or encouraged by an enactment in force in Hong Kong or national law applying in Hong Kong, the exclusion will not apply. Equally, approval or encouragement on the part of the public authorities will not suffice for this general exclusion to apply.

4 Services of General Economic Interest

4.1 Section 3 of Schedule 1 to the Ordinance provides that neither the First Conduct Rule nor the Second Conduct Rule applies to an undertaking entrusted by the Government[28] with the operation of services of general economic interest in so far as the Conduct Rules would obstruct the performance, in law or in fact, of the particular tasks assigned to the undertaking.

4.2 The Commission intends to interpret this general exclusion strictly. The onus will be on the undertaking seeking the benefit of the exclusion to demonstrate that all the conditions for application of the exclusion have been met. In other words, the Ordinance in this exclusion allows for the non-application of the Conduct Rules only under strict terms. These are discussed below.

Entrusted

4.3 The undertaking will need to demonstrate that it has been expressly entrusted by the Government with the service in question. The Commission considers that an act of entrustment may be made by way of some legislative measure or regulation, through the grant of a concession or license governed by public law or through some other act of the Government. Mere approval by the Government of the activities carried out by the relevant undertaking will not suffice.

4.4 The exclusion applies only to the particular entrusted tasks and not to the undertaking or its activities generally.

[28] Section 3 of the Interpretation Ordinance provides that the term "Government" means the Government of the Hong Kong Special Administrative Region. Section 2 of the Ordinance indicates, however, that Government does not include a company that is wholly or partly owned by the Government.

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4.5 For obligations imposed on an undertaking entrusted with the operation of a service of general economic interest to fall within the particular tasks entrusted to it, they must be linked to the subject matter of the service of general economic interest in question and contribute directly to achieving that interest.

Services of general economic interest

4.6 The Commission considers that the reference to "services" in this context includes the distribution of goods and not only the provision of services.

4.7 Services of general economic interest are services that the public authorities believe should be provided to the public whether or not the private sector would supply the relevant services.[29] The reference to "economic" refers to the economic nature of the service provided. For example, services of an economic nature may include activities in the cultural, social, and public health fields where their aim is to make a profit.

4.8 To be considered a service of general economic interest, the service must typically be widely available and not restricted to a certain class, or classes, of buyers. That said, services aimed a particular group or a particular locality, for example a disadvantaged group or a remote locality, could still qualify in so far as such services are in the general interest.

Obstruct the performance, in law or in fact, of the particular tasks assigned

4.9 To benefit from the services of general economic interest exclusion, it will not be sufficient for an undertaking merely to provide evidence that it has been entrusted with the performance of a particular service of general economic interest. Rather, the undertaking must also demonstrate that the application of the Conduct Rules would obstruct the performance of the relevant entrusted tasks.

4.10 An undertaking seeking to demonstrate that the application of the Conduct Rules would obstruct the performance of the entrusted tasks must show with supporting evidence that the application of those rules would require it to perform the entrusted tasks under economically unacceptable conditions. The undertaking will also generally need to show that the entrusted tasks could not be discharged in other ways, which would cause less harm to competition.

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[29] The concept of a service of general economic interest might be seen as roughly corresponding to the concept of a public service.

5 Mergers

5.1 Section 3 of Schedule 7 to the Ordinance provides that agreements or conduct, which result in, or if engaged in would result in, a "merger" are excluded from the Conduct Rules. A merger, as defined in the Ordinance, takes place where:

(a) two or more undertakings previously independent of each other cease to be independent of each other;

(b) one or more persons or other undertakings acquire direct or indirect control of the whole or part of one or more other undertakings;

(c) there is an acquisition by one undertaking (the "acquiring undertaking") of the whole or part of the assets (including goodwill) of another undertaking (the "acquired undertaking") which results in the acquiring undertaking being in a position to replace, or to substantially replace, the acquired undertaking, in the business or in part of the business concerned (as the case requires) in which the acquired undertaking was engaged immediately before the acquisition; or

(d) a joint venture is created to perform, on a lasting basis, all the functions of an autonomous economic entity.

5.2 The application of the exclusion for mergers is discussed in detail in Part 6 of this Guideline.

6 Agreements of Lesser Significance

6.1 Section 5 of Schedule 1 to the Ordinance contains a general exclusion for agreements of lesser significance. Pursuant to that provision (but subject to paragraph 6.3 below), the First Conduct Rule does not apply to:

(a) an agreement between undertakings in any calendar year if the combined turnover of the undertakings for the turnover period[30] does not exceed HK$200 million;

(b) a concerted practice engaged in by undertakings in any calendar year if the combined turnover of the undertakings for the turnover period does not exceed HK$200 million; or

(c) a decision of an association of undertakings in any calendar year if the turnover of the association for the turnover period does not exceed HK$200 million.

[30] Pursuant to section 5(3) of Schedule 1 to the Ordinance, the turnover period of an undertaking is (a) if the undertaking has a financial year, the financial year of the undertaking that ends in the preceding calendar year; or (b) if the undertaking does not have a financial year, the preceding calendar year. Additional rules concerning the appropriate turnover period will be contained in regulations made by the Secretary for Commerce and Economic Development under section 163(2) of the Ordinance.

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6.2 Turnover for the purposes of the above exclusion for agreements of lesser significance means the total gross revenues of an undertaking whether obtained in Hong Kong or outside Hong Kong. In the case of an association of undertakings, turnover means the total gross revenues of all the members of the association whether obtained in Hong Kong or outside Hong Kong.

6.3 The general exclusion for agreements of lesser significance applies in respect of all conduct falling within scope of the First Conduct Rule other than Serious Anti-competitive Conduct as that term is defined in section 2(1) of the Ordinance.

6.4 Additional rules in respect of the calculation of relevant turnover for the purposes of this particular general exclusion will be contained in regulations made by the Secretary for Commerce and Economic Development under section 163(2) of the Ordinance.

7 Block Exemption Orders

7.1 Section 15 of the Ordinance provides that if the Commission is satisfied that a particular category of agreement is excluded from the application of the First Conduct Rule by or as a result of section 1 of Schedule 1 to the Ordinance, the Commission may issue a Block Exemption Order in respect of that category of agreement. Block Exemption Orders that have been made by the Commission, if any, will be available on the Commission's website.[31]

7.2 Where an agreement falls within scope of a Block Exemption Order issued by the Commission, the agreement is exempt from application of the First Conduct Rule under section 17 of the Ordinance.

8 Public Policy and International Obligations Exemptions

8.1 Sections 31 and 32 of the Ordinance provide for exemptions on public policy grounds ("**Public Policy Exemption**") and to avoid a conflict with international obligations[32] that directly or indirectly relate to Hong Kong ("**International Obligations Exemption**").

[31] Further information on the Commission's approach to making Block Exemption Orders is available in the Commission's *Guideline on Applications for a Decision under Sections 9 and 24 (Exclusions and Exemptions) and section 15 Block Exemption Orders.*

[32] Under section 32 of the Ordinance an international obligation "*includes an obligation under – (a) an air service agreement or a provisional arrangement referred to in Article 133 of the Basic Law; (b) an international arrangement relating to civil aviation; and (c) any agreement, provisional arrangement or international arrangement designated as an international agreement, international provisional arrangement or international arrangement by the Chief Executive in Council by order published in the Gazette*".

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8.2 Unlike the Schedule 1 exclusions which are listed in the Ordinance, these two exemptions require that the Chief Executive in Council make an order specifying that a particular agreement or conduct or a particular class of agreement or conduct is exempt from the Conduct Rules.

8.3 Sole responsibility for making Public Policy Exemption and International Obligations Exemption orders (and the associated criteria) rests with the Chief Executive in Council. In so far as the First Conduct Rule is concerned, the Commission's role in respect of these exemptions, if any, is confined to determining whether they apply in a particular case following an application for a decision under section 11 of the Ordinance.

8.4 Public Policy Exemption and International Obligation Exemption orders that have been made by the Chief Executive in Council, if any, will be made available on the Commission's website.

9 Statutory Bodies and Specified Persons

9.1 Section 3 of the Ordinance provides that the First Conduct Rule does not apply to statutory bodies. [33] Under section 3, statutory bodies are excluded from the competition rules (including the First Conduct Rule) unless they are specifically brought within the scope of those rules by a regulation made by the Chief Executive in Council under section 5.

9.2 The reference to a statutory body in section 3 of the Ordinance includes an employee or agent of the statutory body acting in that capacity. The section 3 exclusion does not, however, extend to legal entities owned or controlled by a statutory body unless those entities are also statutory bodies.[34] Moreover, the section 3 exclusion does not extend to undertakings that might enter into anti-competitive arrangements with an excluded statutory body. These undertakings remain subject to the Ordinance.

9.3 All regulations that might be made by the Chief Executive in Council under section 5 of the Ordinance will be made available on the Commission's website.

[33] As defined in section 2 of the Ordinance, "statutory body" means "*a body of persons, corporate or unincorporate, established or constituted by or under an Ordinance or appointed under an Ordinance, but does not include (a) a company; (b) a corporation of trustees incorporated under the Registered Trustees Incorporation Ordinance (Cap 306); (c) a society registered under the Societies Ordinance (Cap 151); (d) a co-operative society registered under the Co-operative Societies Ordinance (Cap 33); or (e) a trade union registered under the Trade Unions Ordinance (Cap 332)*".

[34] In any event, the definition of statutory body does not include a "company" as defined in the Ordinance (including a company within the meaning of section 2(1) of the Companies Ordinance).

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