

# Revised Draft Guideline on **The First Conduct Rule**

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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**”).*

*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.<sup>1</sup> Unless stated otherwise, where a matter relates to conduct falling within this concurrent jurisdiction, references in this Guideline to the Commission also apply to the CA.*

*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 and does not have binding legal effect. The Competition Tribunal (the “**Tribunal**”) and other courts are responsible ultimately for interpreting the Ordinance. The Commission’s interpretation of the Ordinance does not bind them. The application of this Guideline may, therefore, need to be modified in light of the case law of the courts.*

*The Guideline describes the general approach which the Commission intends to apply to the topics covered in the Guideline. The approach described will be adapted, as appropriate, to the facts and circumstances of the matter.*

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<sup>1</sup> 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**”), other 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.

## I The First Conduct Rule

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- 1.1 This Guideline provides a framework for the Commission's analysis of conduct under the First Conduct Rule. The Guideline will also help undertakings to determine whether their conduct complies with the First Conduct Rule.
- 1.2 Consumers (including businesses acting as customers)<sup>2</sup> benefit from competitive rivalry in the marketplace. Hong Kong's free market economy depends on a healthy competitive environment which incentivises businesses to offer a wider variety of better quality products<sup>3</sup> at lower prices.
- 1.3 Most agreements and arrangements between market participants benefit consumers and the Hong Kong economy. Cooperation between businesses can often stimulate more efficient, cost-effective and innovative business practices. However, the benefits of a competitive market are undermined when market participants collude with their competitors<sup>4</sup> on key parameters of competition such as price, output, product quality, product variety and innovation.
- 1.4 The proposition that 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 to any agreement or arrangement between parties who are not competitors if the agreement or arrangement has the object or effect of harming competition<sup>5</sup> in Hong Kong.

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<sup>2</sup> References to consumers in this Guideline includes businesses acting as customers unless the context otherwise dictates.

<sup>3</sup> References to products in this Guideline includes services unless the context otherwise dictates.

<sup>4</sup> References to a competitor or competitors in this Guideline includes a potential competitor or potential competitors unless the context otherwise requires.

<sup>5</sup> This Guideline uses the shorthand "harm competition" in place of "prevent, restrict or distort 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 form of conduct involving two or more parties for the First Conduct Rule to apply. The First Conduct Rule applies to 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. The term undertaking is a broader concept than the term company although a company may be an undertaking. The term undertaking is explained in detail in Part 2 of this Guideline.
- 1.8 The First Conduct Rule also applies to decisions of an association of undertakings which have the object or effect of harming competition in Hong Kong. A trade association is an example of an association of undertakings. Members of trade associations are prohibited from making or giving effect to trade association decisions which harm competition.
- 1.9 Conduct which is in principle subject to the First Conduct Rule may be excluded or exempt from its application by virtue of:<sup>6</sup>
- (a) the general exclusions provided for in Schedule 1 to the Ordinance;
  - (b) the exemptions provided for in section 31 (public policy) and section 32 (international obligations) of the Ordinance; or
  - (c) the disapplication of certain provisions of the Ordinance to statutory bodies, specified persons and persons engaged in specified activities as provided for in sections 3 and 4 of the Ordinance.
- 1.10 In particular, Schedule 1 to the Ordinance recognises that agreements<sup>7</sup> between undertakings, even where they harm competition, might sometimes generate efficiencies which compensate for the harm to competition. In this context, section 1 of Schedule 1 provides that the First Conduct Rule does not apply to an agreement which enhances overall economic efficiency. The exclusion for agreements enhancing overall economic efficiency is discussed in Part 4 of this Guideline and in the Annex.

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<sup>6</sup> These various exclusions and exemptions are discussed in detail in the Annex to this Guideline.

<sup>7</sup> 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.

- 1.11 Schedule 1 to the Ordinance also excludes certain conduct engaged in by small and medium-sized enterprises (“**SMEs**”) from the application of the First Conduct Rule. In that respect, section 5 of Schedule 1 contains a general exclusion for agreements of lesser significance. The exclusion for agreements of lesser significance is discussed in the Annex.
- 1.12 The application of the First Conduct Rule as described in this Guideline does not preclude the parallel application of the Second Conduct Rule to the same conduct. Conduct in the form of an agreement that harms competition and therefore contravenes the First Conduct Rule might also contravene the Second Conduct Rule where the agreement involves an abuse of a substantial degree of market power:<sup>8</sup>
- 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 of Hong Kong.

## 2 Terms Used in the First Conduct Rule

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- 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 or subcontractors, 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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<sup>8</sup> See the *Guideline on the Second Conduct Rule* for guidance on how the Commission intends 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 of offering products in a market regardless of whether the activity is intended to earn a profit.
- 2.4 The Commission considers that an entity may be an undertaking for certain of its activities but may not be an undertaking for other activities. Where the relevant activities are economic, the entity is an undertaking with respect to those activities for the purposes of the Ordinance.
- 2.5 An individual acting as a final consumer is not an undertaking under the Ordinance.

### ***Single economic unit***

- 2.6 The First Conduct Rule does not apply to conduct involving two or more entities if the relevant entities are part of the same undertaking. To determine whether two (or more) entities are a single undertaking for the purposes of the First Conduct Rule, the Commission will assess whether the relevant entities constitute a single economic unit.
- 2.7 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 (Cap 622) or other laws.
- 2.8 Whether or not separate entities form a single economic unit depends on the facts of the case. Generally, if entity A exercises decisive influence over the commercial policy of entity B, whether through legal or *de facto* control, then the Commission will consider A and B a single economic unit and part of the same undertaking.
- 2.9 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 notwithstanding that these various entities might have separate legal personalities.

- 2.10 Whether a joint venture entity forms a single undertaking with any one of its parents depends on the facts of the case. Generally, if two or more parent entities have power to block actions which determine the strategic commercial behaviour of the joint venture (i.e. if there is joint control – including *de facto* control), the joint venture is not part of the same economic unit as any of its parents.

### ***Independent distributors and distribution agents***

- 2.11 Suppliers commonly use third parties to distribute their products. Whether the First Conduct Rule applies to the relationship with such third parties depends on whether or not the third party is a separate undertaking from the supplier i.e. whether or not the supplier and the third party are part of the same single economic unit.
- 2.12 Where a supplier enters into a distribution agreement with an independent third party distributor the agreement will in principle be subject to the First Conduct Rule as the supplier and distributor are separate undertakings.
- 2.13 In certain cases, however, a supplier may appoint a third party to negotiate and/or conclude contracts on behalf of the supplier for the sale of the supplier's products. Here the third party acts as a distribution agent for the supplier.
- 2.14 Whether a third party acts as a true distribution agent does not depend on whether that party is labelled an "agent" or the agreement appointing the third party is labelled an "agency agreement". Rather, the relevant factors are the level of control which the supplier exercises over the third party and the level of financial or commercial risk borne by the third party in relation to the activities for which it has been appointed as a distribution agent by the supplier.



2.15 In particular, the Commission may consider that a distributor acts as a true distribution agent of the supplier if it does not bear any, or bears only insignificant, risks in relation to the contracts concluded on behalf of the supplier. This might be the case where (i) title to the contract products is not transferred to the distributor<sup>9</sup> and (ii) the distributor does not bear any or bears only an insignificant portion, of the following non-exhaustive types of risks and costs:

- (a) costs linked to the distribution of the contract products including transport costs;
- (b) costs or risks associated with the maintenance of stocks of the contract products (e.g. costs relating to loss of stocks or where the distributor must bear the costs of unsold stock);
- (c) responsibility for damage caused by contract products sold to third parties (product warranty);
- (d) costs or risks associated with non-performance by customers (e.g. late or non-payment by the customer);
- (e) costs associated with advertising or sales promotion for the contract products;
- (f) costs associated with market-specific investments in equipment, premises or the training of personnel; and
- (g) costs associated with other activities in the same product market as the contract products where these activities are required by the supplier.

2.16 Where a supplier appoints a distributor for the purposes of distributing its products and that distributor is a true distribution agent of the supplier pursuant to the principles explained above, the Commission considers that the selling function of the distributor with respect to the contract products forms part of the same undertaking as the supplier. The First Conduct Rule, therefore, does not apply to restrictions imposed in the distribution agreement on the distributor in so far as they relate to the contracts concluded on behalf of the supplier. This includes restrictions imposed on the distributor which limit the customers with whom the distributor can deal, the territories where the distributor can sell or the prices and conditions at which the distributor can sell the contract products.

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<sup>9</sup> Or, in the case of services, the third party does not itself supply the contract services.

- 2.17 The First Conduct Rule may, however, continue to apply to other aspects of the relationship with the distributor which do not relate to the sale of the contract products but govern the relationship between the distributor and the supplier more generally (such as an exclusive agency provision).

### **Hypothetical Example I**

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 independent third parties who are party to a contract with the manufacturer 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 bear a number of risks in relation to selling the contract products including the cost of certain advertising, delivery and installation services, responsibility for product warranty risks toward customers, and the risk of unsold stock.

The level of risk assumed by the retailers under the Agency Agreement would tend to suggest that they are separate undertakings from the manufacturer conducting business on their own account. This is irrespective of the title of the agreement. The resale pricing provision of the Agency Agreement would therefore be subject to the First Conduct Rule.<sup>10</sup>

### ***Employees and trade unions***

- 2.18 The Commission does not consider an employee to be an undertaking. Discussions or arrangements in relation to salary or other working conditions between one or more employees and their employer take place within the framework of a single economic unit and are outside of scope of the First Conduct Rule.

<sup>10</sup> 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.

2.19 Where a trade union acts as on behalf of its members in collective bargaining with an employer on terms and conditions of work, the trade union is not engaged in economic activity and is not an undertaking.<sup>11</sup> Arrangements with respect to employees' salaries and conditions of work agreed with the relevant employer during the collective bargaining fall outside of scope of the First Conduct Rule.

### **Self-employed persons**

2.20 In general, self-employed persons who offer services in the market, whether or not they are incorporated, are considered to be undertakings for the purposes of the Ordinance.

2.21 In some limited circumstances a self-employed person may not be considered an undertaking. This may be the case where the relationship between the self-employed person and an undertaking hiring the self-employed person is similar to that which exists between an employee and an employer. In other words for the purposes of the Ordinance, the self-employed person may be regarded in these circumstances as a *de facto* employee.

### **Agreement**

2.22 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.

2.23 In determining whether there is an agreement, the Commission will generally 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.

2.24 An undertaking may be found to be party to an agreement or, in the alternative a concerted practice, if it attended a meeting at which an anti-competitive agreement is reached and it failed to sufficiently object to, and publicly distance itself from, the agreement or the discussions leading to the agreement. This may be the case regardless of whether it played an active part in the meeting or intended subsequently to implement the agreement.<sup>12</sup>

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<sup>11</sup> A trade union may, however, act as an undertaking where it carries on an economic activity in its own right, such as by operating a supermarket, a travel agency or other business. In this circumstance, the First Conduct Rule would apply to these activities of the trade union.

<sup>12</sup> To effectively distance itself from the anti-competitive agreement in such a case, the undertaking must demonstrate that it had clearly indicated to its competitors that it participated in the relevant meeting without any anti-competitive intention. This may entail the undertaking evidencing that it had in fact withdrawn from the meeting once the anti-competitive nature of the meeting had become apparent.

- 2.25 An anti-competitive arrangement might comprise a series of sub-agreements concluded as part of a series of activities by the undertakings in pursuit of a common objective of harming competition. Where this is the case, the Commission may consider that the various sub-agreements form part of a single overarching agreement for the purposes of the First Conduct Rule.
- 2.26 The Commission considers that it is not necessary to show that an undertaking participated in or agreed to each and every aspect of an anti-competitive agreement for the undertaking to be held responsible for the agreement as a whole. For example, it is not necessary to show that an undertaking attended every meeting of a cartel arrangement. An undertaking may be found to be a party to and responsible for an overall cartel agreement even though it participated only in certain of its constituent elements if it can be shown that the undertaking knew, or should have known, that the collusion in which it participated was part of an overall plan intended to harm competition.

### **Concerted practice**

- 2.27 The First Conduct Rule also applies to cooperation between undertakings which constitutes 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 of a concerted practice is the notion that undertakings should determine independently the strategy which they adopt in the market and in particular their policies as regards price, product quality and other competitive parameters.
- 2.28 A concerted practice typically involves an exchange of competitively sensitive information between competitors. Whether the exchange of such information is made as part of a concerted practice depends, however, on the circumstances of the case. The Commission will likely conclude that there exists a concerted practice with the object of harming competition where competitively sensitive information such as an undertaking's planned prices or planned pricing strategy is exchanged between competitors in circumstances where:
- (a) the information is given with the expectation or intention that the recipient will act on the information when determining its conduct in the market; and
  - (b) the recipient does act or intends to act on the information.

- 2.29 Without a legitimate business reason for an information exchange of this kind, the Commission will likely infer from the information exchange that the party providing the relevant information had the requisite expectation or intention to influence a competitor's conduct in the market.
- 2.30 Similarly, absent a legitimate business reason for taking receipt of the information exchanged or other evidence showing that the recipient did not act or intend to act on the information when determining its conduct in the market, the Commission will likely infer that the recipient undertaking acted on or intended to act on the information exchanged.

### **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 evidence of a concerted practice. In a competitive market, each language school would 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 concerted practice has the effect of removing all uncertainty between the schools as to their respective fee-setting policies. This conduct harms competition and leads to higher prices.

### Hypothetical Example 3

A highly specialised 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 evidence of a concerted practice between the three insurance providers. The Commission would likely infer 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.

- 2.31 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 is not a concerted practice.

## **Decision of an association of undertakings**

- 2.32 In addition to agreements between undertakings and concerted practices, the First Conduct Rule applies to decisions of an association of undertakings that have the object or effect of harming competition.
- 2.33 The Commission considers that the prohibition in the First Conduct Rule of a decision of an association of undertakings which has the object or effect of harming competition is intended to prohibit indirect anti-competitive cooperation between undertakings through an association.
- 2.34 The reference to association of undertakings in the First Conduct Rule is not limited to any particular kind of association. Examples of associations of undertakings include trade associations, cooperatives, professional associations or bodies, societies, associations without legal personality, associations of associations etc. The mere fact that a professional association has statutory or regulatory functions does not mean that it is not an association of undertakings or that its decisions do not have the object or effect of harming competition.
- 2.35 The Commission considers a decision of an association of undertakings to include, without limitation, the constitution of the association, rules of the association, resolutions, rulings, decisions, guidelines or recommendations of the association, whether made by the board, members, a committee or an employee of the association.
- 2.36 A decision of an association may fall within the First Conduct Rule even if it is non-binding. For example, recommended fee scales and 'reference' prices of trade and professional associations are decisions of associations of undertakings which the Commission would likely consider as having either the object or effect of harming competition.
- 2.37 Where a decision of an association has the object or effect of harming competition, the decision contravenes the First Conduct Rule and the Commission may commence proceedings against the association or its members.

### 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 HK\$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" product and to protect members' profit margins. Association members generally implemented the price increase.

Although the resolution is non-binding and some members do not comply with it, the Commission would consider the resolution as a decision of the association having the object of harming competition.

The Commission would also consider the conduct in the example to be Serious Anti-competitive Conduct under the Ordinance.

## 3 Object or Effect of Harming Competition

### Introduction

- 3.1 The First Conduct Rule applies where the object or effect of an agreement is to harm competition in Hong Kong. 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. These 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.



## **The object of harming competition**

- 3.3 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. These agreements are considered to have the object of harming competition.
- 3.4 In order to determine whether an agreement has the object of harming competition, regard must be had to the content of the agreement, the way it is implemented and its context (including both the economic and legal context).
- 3.5 Determining the object of an agreement requires an objective assessment of its aims. That is, the object of an agreement refers to the purpose or aim of the agreement viewed in its context and in light of the way it is implemented, and not merely the subjective intentions of the parties. 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.<sup>13</sup>
- 3.6 Although the category of agreements which have the object of harming competition cannot be reduced to an exhaustive list, the concept of an anti-competitive object can only be applied to conduct which is by its very nature harmful to competition in a market.
- 3.7 Agreements between competitors to fix prices, to share markets, to restrict output or to rig bids are agreements which the Commission considers to have the object of harming competition. Agreements of this kind, often called "cartel" agreements, are inherently harmful to competition and are universally condemned.
- 3.8 In the case of agreements between parties at different levels of the supply chain (vertical agreements), resale price maintenance agreements may also be considered by the Commission as having the object of harming competition.

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<sup>13</sup> This is not to say that a subjective intention to harm competition can suffice to show an anti-competitive object. Evidence of subjective intent is merely a factor the Commission can have regard to in its objective assessment of the aims of the conduct.

- 3.9 An examination of the context of an agreement for the purposes of determining whether it has the object of harming competition does not require or involve an analysis of the effects of the agreement in the market. As noted at paragraph 3.2, where it is shown that an agreement has the object of harming competition, the Commission does not need to demonstrate that the agreement has anti-competitive effects. It is sufficient for the Commission to show that the agreement has the potential to harm or is *capable* of harming competition in the relevant context.
- 3.10 Where it is established that an agreement has the object of harming competition, the agreement cannot be defended by the parties showing that the agreement does not in fact have any anti-competitive effects or that such effects are not likely to flow from the agreement.
- 3.11 In examining the relevant context for an agreement, the following factors may show that an agreement does not have the object of harming competition:
- (a) in the case of an agreement between parties at the same level of the supply chain, an examination of the relevant context reveals that the parties are neither competitors nor potential competitors;
  - (b) an examination of the relevant context reveals that at the relevant time there is in fact no competition in the market to be harmed; and/or
  - (c) if the primary objective pursued by an agreement does not contravene the First Conduct Rule, any restrictions which are necessary and proportionate to achieving that primary objective do not have the object of harming competition. Such restrictions will also not contravene the First Conduct Rule.<sup>14</sup>
- 3.12 Section 7(1) of the Ordinance provides that if an agreement has more than one object, it will be capable of contravening the First Conduct Rule if any one of its objects is to harm competition.

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<sup>14</sup> See paragraphs 3.28 to 3.33 of this Guideline for a more detailed discussion of the relevant principles in this context.

- 3.13 The efficiencies listed in section 1 of Schedule 1 to the Ordinance (improvements in production or distribution, factors tending to promote technical or economic progress) are not relevant for determining whether an agreement has the object of harming competition. It is only after it has been established that an agreement has the object (or effect) of harming competition that a consideration of the efficiencies listed in section 1 of Schedule 1 to the Ordinance becomes relevant.
- 3.14 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.
- 3.15 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**

- 3.16 If an agreement does not have an anti-competitive object, it may nevertheless contravene the First Conduct Rule if it has an anti-competitive effect.
- 3.17 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.
- 3.18 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.
- 3.19 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.

- 3.20 Anti-competitive effects on competition within a relevant market are likely to occur where it can be expected that, due to the agreement, one or more of the parties would be able profitably to raise prices or reduce output, product quality and 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.
- 3.21 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.<sup>15</sup>
- 3.22 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.
- 3.23 Market power is, however, a matter of degree. The degree of market power for concerns to arise under the First Conduct Rule is not the same as the degree of market power required for concerns to arise under the Second Conduct Rule and is typically less.
- 3.24 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.<sup>16</sup>

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<sup>15</sup> See Part 2 of the Commission's *Guideline on the Second Conduct Rule*.

<sup>16</sup> A detailed discussion of these various factors is contained in Part 3 of the Commission's *Guideline on the Second Conduct Rule*.

- 3.25 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.
- 3.26 Where the effect of an agreement on the competitive process is insignificant, the Commission considers that the agreement does not contravene the First Conduct Rule on the basis of its effects. For an agreement to have the effect of harming competition, the relevant effect must be more than minimal.<sup>17</sup>
- 3.27 When considering whether an agreement has an effect on competition that is more than minimal, the Commission may take into account the cumulative effect on competition of similar agreements in the relevant market and the contribution which the particular agreement under examination makes to the cumulative effect.

***Restrictions necessary for a legitimate commercial purpose***

- 3.28 Where the main arrangement covered by an agreement is not in itself harmful to competition, the Commission considers that restrictions contained in the agreement which are necessary for the agreement to be workable (sometimes termed ancillary restrictions) fall outside the prohibition in the First Conduct Rule.
- 3.29 Accordingly, if the main purpose of an agreement is not harmful to competition, it becomes necessary to assess whether particular individual restrictions contained in the agreement do not contravene the First Conduct Rule because they are ancillary to the main purpose of the agreement. This principle may be particularly relevant, for example, in the context of an assessment of a distribution agreement or a joint venture under the First Conduct Rule.

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<sup>17</sup> This proposition does not apply in the case of an agreement having the object of harming competition. Parties to an agreement with the object of harming competition may not argue that their agreement does not contravene the First Conduct Rule merely, for example, because they happen to have a very small share of the relevant market.

- 3.30 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 effect of harming competition, restrictions which are directly related to and necessary for implementing the main arrangement will also fall outside the First Conduct Rule.
- 3.31 For a 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.
- 3.32 For the restriction to be truly ancillary it must also be objectively necessary for the implementation of the main arrangement 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.
- 3.33 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 clause between the parent entities and the joint venture might be regarded as ancillary to the joint venture or necessary for the joint venture agreement to be workable for the lifetime of the joint venture.

## **4 Exclusion for Agreements Enhancing Overall Economic Efficiency**

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- 4.1 Agreements that have the object or effect of harming competition may 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 of Schedule 1 to the Ordinance – the general 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 or Tribunal, to any agreement that fulfils the cumulative conditions of the exclusion.
- 4.3 The Commission interprets section 1 of Schedule 1 to the Ordinance as a “defence” that can be invoked by an undertaking in response to an allegation that the First Conduct Rule has been contravened. The Commission is of the view that the burden of demonstrating that the terms of the general exclusion are met rests with the undertaking 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, cartel 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.

## **5 Serious Anti-competitive Conduct**

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- 5.1 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 whose conduct is alleged to constitute the contravention, issue a Warning Notice under section 82 of the Ordinance to the undertaking concerned. The Warning Notice procedure affords an undertaking an opportunity to cease or alter the investigated conduct within a specified warning period.

5.2 In cases of Serious Anti-competitive Conduct:

- (a) the Commission may institute proceedings before the Tribunal without following the Warning Notice procedure; and
- (b) the general exclusion for agreements of lesser significance contained in section 5, Schedule 1 to the Ordinance does not apply.<sup>18</sup>

5.3 Serious Anti-competitive Conduct is a defined term in the Ordinance. 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.”*

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

5.5 Vertical arrangements are, as a general matter, unlikely to be considered Serious Anti-competitive Conduct although the definition of Serious Anti-competitive Conduct does not preclude the possibility (there is no reference in the definition to “competitors”).

5.6 The Commission considers, however, that vertical arrangements may amount to Serious Anti-competitive Conduct in certain cases. For example, in certain circumstances, resale price maintenance may be Serious Anti-competitive Conduct.<sup>19</sup>

<sup>18</sup> See the Annex to this Guideline for a more detailed discussion of the exclusion for agreements of lesser significance.

<sup>19</sup> 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. Further discussion of resale price maintenance is contained in Part 6 of this Guideline.



- 5.7 Whether conduct is considered Serious Anti-competitive Conduct is not part of the determination of whether the conduct contravenes the First Conduct Rule because it has the object or effect of harming competition. The issue of whether the conduct is considered Serious Anti-competitive Conduct only arises after the Commission forms the view that the conduct contravenes the First Conduct Rule. Conduct that is Serious Anti-competitive Conduct may contravene the First Conduct Rule where it has either the object or effect of harming competition.

## **6 Agreements that May Contravene the First Conduct Rule**

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- 6.1 The First Conduct Rule applies to agreements if they have the object or effect of harming competition in Hong Kong. The First Conduct Rule applies to both horizontal agreements and vertical agreements.
- 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.
- 6.3 Horizontal agreements may be particularly liable to harm competition because they involve cooperation between competitors. By way of example, cartel arrangements negatively impact the market giving rise to higher prices, reduced output, reduced product quality and variety and innovation. The First Conduct Rule prohibits these practices.
- 6.4 However, horizontal agreements can also lead to economically beneficial outcomes, in particular, if they combine complementary activities, skills, or assets. Horizontal agreements of this kind allow parties to share risk, save costs, increase investments, pool know-how, enhance product quality and variety and stimulate innovation. The Ordinance does not prohibit agreements which either do not harm competition or which, even if they do harm competition to an extent, have sufficient pro-competitive efficiencies and otherwise satisfy the terms of section 1 of Schedule 1 to the Ordinance.

- 6.5 A vertical agreement is an agreement between undertakings that operate, for the purposes of the agreement, at a different level of the production or distribution chain. For example, where undertaking A produces a raw material, and undertaking B uses the 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 vertical agreements as compared with horizontal agreements are generally less harmful to competition, some vertical agreements may, nonetheless, cause harm to competition.
- 6.7 This may be the case where vertical agreements include restrictions which foreclose existing competition or limit the scope for market entry or expansion. In certain cases, vertical restrictions of competition may also serve to facilitate horizontal coordination between competing suppliers and/or downstream distributors.
- 6.8 However, vertical agreements also frequently improve economic efficiency within a chain of production or distribution by facilitating better cooperation between the participating undertakings. In particular, vertical agreements can lead to a reduction in transaction and distribution costs and/or an optimisation of the parties' sales and investment levels.
- 6.9 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 under the Ordinance. As a general matter, competition concerns will only arise where there is some degree of market power at the level of the supplier, the buyer or at the level of both. Vertical agreements between SMEs will rarely be capable of harming competition.

## **Price Fixing**

- 6.10 Agreements between competitors with the aim of fixing, maintaining, increasing or otherwise controlling prices (generally termed price fixing agreements) are examples of agreements with the object of harming competition.<sup>20</sup>

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<sup>20</sup> In certain cases, an examination of the relevant context for the agreement (pursuant to the principles elaborated in paragraphs 3.3 to 3.15 of this Guideline) may, however, show that the object of the agreement is not to harm competition. For example, where the agreement with respect to price is part of some wider pro-competitive integration of the parties' operations. See further paragraph 6.16 of this Guideline.

- 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 an element of price amounts to price fixing.
- 6.12 Price fixing can be achieved by indirect means. This 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 may be assessed as price fixing.<sup>21</sup>
- 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 arise through the activities of a trade association or professional body. For example, the association might issue a recommendation to members on prices and/or publish (possibly non-binding) fee scales for members. The non-binding price recommendations or fees scales of a trade association will likely be assessed as having the object of harming competition, as ultimately these arrangements may not differ in substance to a direct agreement or concerted practice between the members of the association.
- 6.15 The Commission considers that horizontal price fixing agreements are Serious Anti-competitive Conduct under the Ordinance.
- 6.16 The Commission notes that certain legitimate commercial arrangements may involve parties agreeing on pricing within the context of the relevant arrangements. For example, the parties to a production joint venture might agree that the joint venture will sell its jointly produced products at a particular price. In this respect, the Commission takes the view that the joint setting of the price of such products will not be considered as having the object of harming competition if, for example, the joint sales are necessary for the joint production to be implemented.<sup>22</sup>

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<sup>21</sup> See paragraphs 6.38 to 6.49 of this Guideline for a discussion of when exchanges of information may give rise to competition concerns.

<sup>22</sup> See also paragraphs 3.28 to 3.33 of this Guideline which concern restrictions necessary for a legitimate commercial purpose.

### 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, particular elements of price competition have been agreed by the competitors when these matters should be determined independently.

As the conduct has the object of harming competition, it is not necessary for the Commission to consider whether the conduct has or is likely to cause harmful effects on competition in the relevant market.

The Commission would also consider the conduct in the example to be Serious Anti-competitive Conduct under the Ordinance.

### Market Sharing

6.17 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 (non-poaching agreements); or
- (d) expand into a market where another party to the agreement is already active – for example an agreement not to enter a particular geographical area or an agreement not to begin selling certain products.

- 6.18 Agreements between competitors with the aim of sharing markets have the object of harming competition. Even a mere understanding that parties will not supply a competitor's existing customers, and/or will encourage such customers to stay with their existing supplier should the customer seek to switch supplier, can be considered a market sharing agreement with the object of harming competition.
- 6.19 The Commission considers that horizontal market sharing agreements are Serious Anti-competitive Conduct under the Ordinance.
- 6.20 The Commission notes, however, that certain legitimate commercial arrangements may involve parties agreeing to "share markets". For example, competitors might agree to cease production of certain products so that they can specialise in the production of other products which they then supply to each other on a reciprocal basis. An objective assessment of the nature of such an arrangement viewed in its context may lead to the conclusion that the arrangement does not have the object of harming competition.

#### **Hypothetical Example 6**

A group of coach companies supplying services to residents at particular residential buildings 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 buildings based on the total projected number of passengers. They agree not to provide services or to pursue customers which have been allocated to another company. They also agree not to launch new services without consulting each other.

This agreement not to compete with one another defined customer's has the object of harming competition. The agreement removes a choice of supplier with the likely result of higher prices for the services concerned.

Having concluded that the agreement has the object of harming competition, the Commission is not required to show that the conduct has or is likely to have harmful effects in the market.

The agreement is unlikely to satisfy the conditions of section 1 of Schedule 1 to the Ordinance. While it might be argued that the agreement can be defended on the grounds that it rationalises and avoids overlapping services, the arrangement entails the elimination of all competition between the parties concerned and on this basis the terms of section 1 of Schedule 1 are unlikely to be satisfied.

The Commission would also consider the conduct in the example to be Serious Anti-competitive Conduct under the Ordinance.

## Output Limitation

- 6.21 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.
- 6.22 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. Such arrangements may also have other anti-competitive effects, for example, by aligning product quality and/or facilitating collusion between suppliers on price.
- 6.23 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. They will be considered as having the object of harming competition.
- 6.24 The Commission considers that horizontal output limitation agreements are Serious Anti-competitive Conduct under the Ordinance.
- 6.25 The Commission notes, however, that certain legitimate commercial arrangements may involve parties agreeing on output. For example, the parties to a joint venture might agree to a particular level of output for the joint venture. Viewed in its context, the Commission may not consider this sort of arrangement 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.

The Commission would also regard the conduct as Serious Anti-competitive Conduct within the meaning of the Ordinance.

### Bid-Rigging

- 6.26 Bid-rigging generally involves two or more undertakings agreeing that they will not compete with one another for particular projects. For example, they might agree among themselves which bidder will be the winner – the outcome of an ostensibly competitive process is “rigged”.
- 6.27 Bid-rigging is defined in section 2(2) of the Ordinance for the purposes of determining whether the conduct is Serious Anti-competitive Conduct in the form of bid-rigging. Bid-rigging which contravenes the First Conduct Rule is not, however, necessarily limited to the conduct defined in section 2(2). For example, as stated in section 2(2) of the Ordinance, if the bid-rigging is “*made known to the person calling for or requesting bids at or before the time when a bid is submitted or withdrawn by a party*”, the conduct does not fall within the definition of bid-rigging in section 2(2) and is, therefore, not Serious Anti-competitive Conduct in the form of bid-rigging. The bid-rigging conduct may, however, still contravene the First Conduct Rule if it has the object or effect of harming competition.



6.28 Bid-rigging can take a number of forms, including undertakings agreeing:

- (a) that certain parties will not submit a bid or will withdraw a bid submitted previously (“bid suppression”);
- (b) to take turns at being the winning bidder (“bid rotation”);
- (c) that certain bidders will submit higher bid prices or less attractive terms than the supplier “chosen” to win the tender (“cover bidding”); or
- (d) to 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.

6.29 Bid-rigging is inherently anti-competitive and has the object of harming competition in contravention 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 major 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 company calling for the bids 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.

The Commission would also regard the conduct in the example to be Serious Anti-competitive Conduct under the Ordinance.

6.30 Bid-rigging practices should be distinguished from legitimate forms of joint tendering. While bid-rigging will be considered as having the object of harming competition, joint tendering will generally be assessed by reference to its actual or likely effects on competition. Joint tendering is discussed further in paragraphs 6.101 to 6.106 of this Guideline.



## Joint Buying

- 6.31 A joint or group buying agreement arises when undertakings agree to jointly purchase products including inputs used for the production of other products.
- 6.32 Joint buying can be carried out in a number of ways, for example through a jointly controlled legal entity, through an association, by a contractual arrangement between undertakings, or some looser form of cooperation.
- 6.33 Joint buying frequently allows SME undertakings to achieve purchasing efficiencies similar to their larger competitors. This may result in lower prices in the market where the joint buying takes place, lower transaction costs, and/or distribution efficiencies for the SMEs. Joint buying of this kind seldom gives rise to competition concerns.
- 6.34 A joint buying arrangement would typically not be considered by the Commission to have the object of harming competition unless it is a disguised buyers' cartel.<sup>23</sup> Joint buying arrangements, including any agreement by members of the buying group of the prices to pay suppliers, will be analysed as to whether the effects, actual or likely, of the arrangements are harmful to competition.
- 6.35 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.
- 6.36 Harmful effects on competition in the downstream market may occur if, for example, the joint buying results in competitors in the downstream market achieving a high degree of commonality of costs<sup>24</sup> or where there is some sharing of competitively sensitive information<sup>25</sup> beyond what is necessary for the purposes of the buying arrangement. As regards the upstream buying market, concerns may arise if, for example, the joint buying results in the buying market being foreclosed to competing purchasers.
- 6.37 In general, joint buying is unlikely to give rise to concerns under the First Conduct Rule if the parties do not have market power in the relevant downstream markets.

<sup>23</sup> Buyers' cartels while uncommon are considered to have the object of harming competition. An example of a buyers' cartel would be where the buyers collude in secret on the prices they will pay for purchases made individually.

<sup>24</sup> Joint buying and other horizontal co-operation agreements may result in the parties achieving significant commonality of variable costs such that they can more easily coordinate on retail prices and/or output.

<sup>25</sup> See paragraphs 6.38 to 6.49 of this Guideline for a discussion of information exchange under the Ordinance. Competitively sensitive information is explained in paragraph 6.39.

### 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 must buy at least half 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 arrangement does not have the object of harming competition and the Commission would be unlikely to find that the arrangement has any 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.

If the joint buying agreement did give rise to harmful effects on competition, it would still be 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 may therefore apply.

### Exchange of Information

6.38 In the normal course of business, undertakings exchange information on a variety of matters with no risk to the competitive process. Indeed, competition is often enhanced through the sharing of information, for example, in relation to best practices or exchanges of information which allow firms to better predict how demand is likely to evolve. Similarly, information exchanges may facilitate price comparisons by consumers or reduce consumer search costs. As a general proposition, the more informed consumers are, the more effective competition is likely to be.

6.39 However, concerns may arise where undertakings which are competitors exchange information. In particular, this will be the case where competitors exchange information which is competitively sensitive information. Competitively sensitive information includes information relating to price, elements of price or price strategies, customers, production costs, quantities, turnover, sales, capacity, product quality, marketing plans, risks, investments, technologies and innovations. Generally, information relating to price and quantities (information concerning sales, market shares, sales to particular customer groups or territories) is the most competitively sensitive.

### ***Agreements to exchange information which may have the object of harming competition***

6.40 If competitors share information in private on their future individual intentions or plans with respect to price,<sup>26</sup> the Commission will likely consider that the agreement to exchange such information, has the object of harming competition. Similarly, as explained at paragraphs 2.28 to 2.30 of this Guideline, where an exchange of such information arises as part of a concerted practice, the Commission would likely assess the conduct as having the object of harming 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 to members in advance of a seasonal price review by the association members.

Absent a decision of the association giving rise to the information exchange or evidence of an agreement between members to engage in the information exchange, the Commission would infer that this arrangement is implemented as part of a concerted practice with the object of harming competition. The conduct 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.

The Commission would also regard the conduct to be Serious Anti-competitive Conduct under the Ordinance.

<sup>26</sup> The reference to price in this context is shorthand for price and quantities information. See paragraph 6.39 of the Guideline.

### **Information exchanged through a third party**

- 6.41 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.
- 6.42 If undertakings agree with each other to exchange information on their proposed future intentions with respect to price indirectly through a third party conduit such as a common supplier, this will likely be considered a form of price fixing with the object of harming competition.
- 6.43 Equally such an information exchange might occur as part of a concerted practice, for example, if (i) an undertaking exchanges information via a third party functioning as a conduit intending that the third party will make use of the information to influence market conditions by passing it to a competitor of the undertaking, (ii) the third party in fact transmits the information to the competitor and (iii) the competitor uses the information to determine its conduct in the market.<sup>27</sup>

#### **Hypothetical Example 11**

Connaught, Queens and DVo are the main retailers in Hong Kong for a particular type of cosmetic product. CentralCosmetics currently provides its cosmetic products to each of the competing retailers.

Connaught emails Central indicating it plans to raise the retail price of Central's products next month by HK\$5 “if Queens and DVo do the same”. Connaught asks Central to ensure “*this message is understood*”. Central immediately forwards the email to the sales personnel at Queens and DVo. Both reply to Central indicating “*seems like a good idea*”. Central contacts Connaught and informs them that their email was “*well received*”. Connaught proceeds with a price hike the following month. Queens and DVo follow within a couple of days.

The scenario is likely to be viewed as an agreement or at least a concerted practice involving all four undertakings with the object of harming competition. The Commission would also consider the arrangement to be Serious Anti-competitive Conduct under the Ordinance.

<sup>27</sup> See generally paragraphs 2.28 to 2.30 of this Guideline for further information on when an exchange of information might give rise to or take place as part of a concerted practice.

Central is provided with the confidential information by Connaught on the express basis that it should be disseminated to Connaught's competitors and acted upon accordingly. Central clearly understands the intention behind Connaught's email and thus actively participates as the conduit for the sharing of future pricing intentions. Central's role and the various confirmations received from the other retailers has removed the inherent uncertainty in competitive markets. Connaught feels confident that its price rise will be matched and therefore proceeds with the price rise.

### ***Agreements to exchange information which may have the effect of harming competition***

- 6.44 Where an agreement to exchange information does not have the object of harming competition, the Commission will consider whether it might have anti-competitive effects.
- 6.45 Whether or not the exchange of information gives rise to concerns under the First Conduct Rule depends on the circumstances of the case including the characteristics of the market, the type of information exchanged (whether it is competitively sensitive and how competitively sensitive it is) and other relevant factors.
- 6.46 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, 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 agreement to exchange the information will give rise to concerns under the First Conduct Rule.
- 6.47 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,<sup>28</sup> 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.

<sup>28</sup> 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.

- 6.48 In general, the exchange of publicly available information is unlikely to involve a contravention 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. The fact that information could have been gathered from a customer does not mean that the information is publicly available.
- 6.49 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 12

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 products. To address the problem, the suppliers agree to 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.

The Commission is unlikely to consider that this agreement has the object or 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. In any case, the agreement to exchange the information 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

- 6.50 In most circumstances, an undertaking is free to choose with whom it will or will not do business.<sup>29</sup> However, an agreement or concerted practice amongst competitors not to do business with targeted individuals or undertakings may be an anti-competitive group boycott.
- 6.51 The Commission will consider that an agreement to engage in a group boycott has the object of harming competition when, in particular, a group of competitors agrees to exclude an actual or potential competitor.
- 6.52 Where a boycott is intended to facilitate a wider cartel agreement, the boycott is simply part of the cartel. For example, the members of a price fixing cartel might agree to take 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. Evidence of a boycott of this kind is evidence of the implementation of the cartel or evidence, possibly together with other evidence, from which the Commission might infer a cartel agreement.

### Hypothetical Example 13

Companies active in a particular manufacturing 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 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.

<sup>29</sup> Where an undertaking has a substantial degree of market power, a refusal to deal may, however, contravene the Second Conduct Rule. See the Commission’s *Guideline on the Second Conduct Rule* for further detail in this respect.



The recruitment agencies' conduct amounts to an agreement to boycott a competitor with a view to excluding that competitor from the market. The Commission would consider the agreement as having the object of harming competition. The agreement 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.

The Commission would also consider the conduct in the example to be Serious Anti-competitive Conduct within the meaning of point (c) of the definition of Serious Anti-competitive Conduct in the Ordinance.<sup>30</sup>

## **Activities of Trade Associations and Industry Bodies**

- 6.53 Trade associations and similar bodies play a valuable role in the economy in terms of furthering the collective interests of members. Such organisations may represent industry players in dealings with Government or help promote the members' interests in the media. They can assist with collecting and disseminating statistical information of interest to members or serve as a forum for agreeing industry standards or standard terms. They may offer a range of advisory services for members or training. Many of these activities have a positive impact in the economy and they often would not give cause for concern under the Ordinance.
- 6.54 As discussed at paragraphs 2.32 to 2.37 of this Guideline, some activities of a trade association may, however, raise concerns under the First Conduct Rule. The association may contravene the rule if an activity is considered to be a decision of an association of undertakings which has the object or effect of harming competition. An undertaking may contravene the First Conduct Rule if its activities are pursuant to an anti-competitive agreement or concerted practice to which it is a party or if, where the activity is pursuant to a decision of an association of which the undertaking is a member, the undertaking made or has given effect to the decision.
- 6.55 While much of the guidance in this Guideline will be of general relevance for trade associations and industry bodies, the discussion below groups together a number of issues of specific relevance to such organisations.

<sup>30</sup> Namely, conduct consisting of "controlling, preventing, limiting or eliminating the production or supply of goods or services".



### ***Terms of membership of associations which may give rise to competition concerns***

- 6.56 Membership of an association can, 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.
- 6.57 To minimise competition concerns of this kind, the rules of admission to membership of the relevant 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.
- 6.58 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 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 practices having the object or effect of harming competition***

- 6.59 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 quality assurance or promote interoperability between products.
- 6.60 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.
- 6.61 The Commission may, however, 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 such that members were able to advertise themselves as “endorsed” by the professional body. Consumers consider 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” 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”.

This scenario raises concerns under the First Conduct Rule. The change to the rules 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. The Commission will be likely to consider the rule change as having the object of harming competition. Thus, the professional body and/or members who made or gave effect to the decision may contravene the First Conduct Rule.

The Commission would also consider the conduct in the example to be Serious Anti-competitive Conduct under the Ordinance.

### ***Standard terms which may raise a concern under the First Conduct Rule***

- 6.62 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.

- 6.63 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.
- 6.64 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.
- 6.65 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 terms which recommend particular prices) will also be considered as having the object of harming competition.
- 6.66 As a general proposition, 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 and the standard terms are non-binding and accessible to all market participants. However, this 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, an assessment of the effects of the standard terms will be required.

#### **Hypothetical Example 15**

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. 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.

### ***Standardisation agreements under the First Conduct Rule***

- 6.67 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.
- 6.68 However, agreements that use a standard as part of a broader restrictive agreement aimed at excluding actual or potential competitors will likely 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.

### **Vertical Price Restrictions**

- 6.69 Vertical price restrictions are restrictions imposed or recommended by an undertaking which affect the prices at which another undertaking operating at a different level of the production or distribution chain sells products.
- 6.70 The most common example of a vertical price restriction is the situation where a supplier imposes or recommends prices at which another undertaking sells the products it purchases from the supplier – so-called resale price restrictions. Vertical price restrictions are not limited to resale prices, however. While reference is made to resale price restrictions throughout this section, the principles should be understood to apply to vertical price restrictions generally and nothing turns on whether there is or is not a 'resale' as such. The key consideration is whether the vertical price is fixed, whether there is a minimum or maximum price level or whether the price level is merely recommended.

### ***Resale price maintenance***

6.71 Resale price maintenance (“**RPM**”) occurs whenever a supplier establishes a fixed or minimum resale price to be observed by the distributor when it resells the product affected by the RPM obligation.

6.72 RPM can restrict competition in a number of ways:

- (a) RPM facilitates coordination between competing suppliers through enhanced price transparency in the market. In this context, the Commission may have a particular concern where RPM is employed by multiple suppliers in the market or RPM is otherwise common in the market;
- (b) RPM undermines suppliers’ incentives to lower prices to distributors<sup>31</sup> 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.<sup>32</sup> This will be a particular concern where there are strong or well organised distributors operating in a market. RPM facilitates coordination between distributors on the downstream market affected by the RPM. In this context, the Commission will have concern particularly where there is evidence that the RPM conduct is distributor driven;
- (d) RPM prevents the emergence of new market participants at the distributor level and will generally hinder the expansion of distribution models based on low prices (for example, the emergence of discounter distributors); and
- (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 only promote the product affected by the RPM causing harm to consumers.

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<sup>31</sup> While reference is made to distributors throughout the discussion of resale price restrictions, vertical price restrictions can also be imposed on retailers selling to end-consumers. The principles discussed in paragraphs 6.71 to 6.84 apply equally in the case vertical price restrictions imposed on retailers.

<sup>32</sup> The Commission interprets the First Conduct Rule as prohibiting not only restrictions on inter-brand competition but also restrictions on intra-brand competition. Intra-brand competition is competition between products of the same brand. Inter-brand competition is competition between products of differing brands.

- 6.73 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.
- 6.74 For the reasons set out in paragraph 6.72 of this Guideline, where an agreement involves direct or indirect RPM, the Commission takes the view that the arrangement may have the object of harming competition. However, whether this is in fact the case turns on a consideration of the content of the agreement establishing the RPM, the way the arrangement is implemented by the parties and the relevant context.
- 6.75 For example, RPM will be considered as having the object of harming competition if there is evidence that the RPM was implemented by a supplier in response to pressure from a distributor seeking to limit competition from competitors of the distributor at the resale level. Similarly, if the RPM is implemented by a supplier solely to foreclose competing suppliers, the Commission may consider that the RPM has the object of harming competition.

#### **Hypothetical Example 16**

HomeStore is the owner of a wide number of household goods shops across Hong Kong. HomeStore is a significant customer of CleanUpCo for a number of daily use products which are widely available in supermarkets, convenience stores, specialist stores and smaller shops.

HomeStore is concerned that its competitors, including other large chain stores and smaller independent stores, are offering CleanUpCo's products at a lower price than HomeStore. HomeStore is concerned that its competitors' pricing decisions will impact on the profitability of a number of important business lines in its stores. HomeStore therefore pressures CleanUpCo to require its customers to sell CleanUpCo products across Hong Kong at a fixed retail price determined by CleanUpCo. As HomeStore is a significant customer of CleanUpCo, CleanUpCo implements the RPM policy.

The Commission would view this arrangement as having the object of harming competition. HomeStore's insistence on CleanUpCo introducing a fixed retail price across Hong Kong has an inherent ability to harm competition. In this scenario, the purpose of the arrangement is merely to protect HomeStore from the competitive pricing of its competitors. In addition, there would be unlikely to be sufficient justifications for the RPM practice to satisfy the terms of the general exclusion for agreements enhancing overall economic efficiency in section 1 of Schedule 1 to the Ordinance.

The Commission would also consider the RPM in the example to be Serious Anti-Competitive Conduct under the Ordinance.

### **Hypothetical Example 17**

NailCo, a leading 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 for NailCo products across Hong Kong. NailCo also 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 be likely to satisfy the terms of the general exclusion for agreements enhancing overall economic efficiency in section 1 of Schedule 1 to the Ordinance. These 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.

- 6.76 If RPM does not have the object of harming competition, the Commission will assess whether the RPM causes harm to competition by way of its effects.



6.77 For example, where a supplier introduces a new product, a RPM arrangement may serve to induce distributors to better take into account the supplier's interest in promoting the product during the introductory period of expanding demand. In this context, the RPM might incentivise increased sales or promotional efforts on the part of the distributors. Similarly, RPM may be of assistance in a franchise distribution system for the purposes of organising a coordinated price campaign of limited duration. In both of these scenarios the Commission would consider that the RPM does not have the object of harming competition and would therefore assess whether the arrangement had any harmful effects on competition.

### Hypothetical Example 18

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 a fixed resale price of HK\$5 – which the producer understands to be a lower price than those of the leading 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 in so far as the agreement reduces the ability of independent retailers to set the price of the new products as they see fit.

However, the RPM when viewed in its context does not have the object of harming competition. Rather, the arrangement is intended objectively to assist a particular supplier break into the Hong Kong market. Accordingly the Commission would proceed to an analysis of the effects of the arrangement. On the facts, including the small market presence of the relevant supplier, the Commission might be able to conclude that the RPM does not give rise to concerns under the First Conduct Rule on the basis of its effects.



Even assuming that the RPM in this case might be assessed as having either the object or effect of harming competition, 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 important to allow a new product to establish itself in the market. From this perspective, the fixed price encourages retailers to stock the product, increase sales through promotional activities and thus expands overall demand thereby improving 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.

#### ***Recommended or maximum prices***

- 6.78 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.
- 6.79 Instead, an agreement which entails recommended or maximum resale prices will be subject to an analysis of its competitive effects.
- 6.80 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.
- 6.81 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.

- 6.82 This could include, for example, the use of a price monitoring system, or an obligation on distributors to report other members of a distribution network that deviate from the recommended or maximum price level or other measures which reduce the distributor's incentive to lower the resale price. While the presence of these practices or similar mechanisms may support a conclusion that ostensibly recommended or maximum resale price arrangements function in reality as RPM, this is not inevitably the case and the position must be assessed in light of all available facts.
- 6.83 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.

#### ***Efficiency justifications for vertical price restrictions***

- 6.84 Vertical price restrictions, including RPM, may sometimes lead to efficiencies of the type detailed in section I of Schedule I to the Ordinance. While efficiencies must be assessed on a case by case basis, examples of possible efficiency arguments which may have relevance for vertical price restrictions are given below:<sup>33</sup>
- (a) RPM may help address so-called free rider problems at the distribution 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 some relevance in the case of "experience" or complex products but the Commission would expect to see compelling evidence of an actual free rider problem; or
  - (b) 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".<sup>34</sup>

<sup>33</sup> The discussion here in respect of efficiencies is subject to the more detailed discussion in the Annex. Undertakings will be required to substantiate efficiencies and may not simply assert them. 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.

<sup>34</sup> 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.

## **Exclusive Distribution and Exclusive Customer Allocation**

- 6.85 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.
- 6.86 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 in the relevant market, including an assessment of how intra-brand and inter-brand competition<sup>35</sup> 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.
- 6.87 If an exclusive distribution or exclusive customer allocation agreement is considered to have anti-competitive effects, the agreement may nonetheless benefit from the general exclusion for agreements enhancing overall economic efficiency set out in section 1 of Schedule 1 to the Ordinance. If the agreement meets the cumulative conditions of this exclusion, the First Conduct Rule does not apply to the agreement. 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 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.
- 6.88 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.

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<sup>35</sup> As explained in footnote 32 of this Guideline, intra-brand competition is competition between products of the same brand. Inter-brand competition is competition between products of differing brands.

- 6.89 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 19

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" clause 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.

## Joint Ventures

- 6.90 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 selling, distribution and marketing arrangements, and joint R&D ventures. The activities of a joint venture may be carried out through a legal entity separate from the parties to the joint venture or by some or all parties to the joint venture.

- 6.91 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.
- 6.92 The Commission considers the following non-exhaustive factors as providing an indication that a joint venture does not perform, on a lasting basis, all the functions of an autonomous economic entity and is therefore within scope of the Conduct Rules. 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 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.
- 6.93 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.
- 6.94 As explained at paragraphs 3.28 to 3.33 of this Guideline, if the joint venture agreement viewed as a whole does 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 clause between the parent entities and their joint venture might be regarded as directly related to and necessary for implementing the joint venture for the lifetime of the joint venture.

### ***Production joint ventures***

- 6.95 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.
- 6.96 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.
- 6.97 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 the 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.
- 6.98 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.
- 6.99 Joint production agreements may sometimes have the effect of harming competition, for example, where:
- (a) producing jointly leads to reduced product variety in the markets where the joint venture partners competed prior to forming the joint venture;
  - (b) producing jointly results in higher prices for customers;
  - (c) producing jointly results in an increase in the parties' commonality of costs with the result that the parties can more easily coordinate market prices; or
  - (d) the agreement leads to an exchange of competitively sensitive information beyond that which is strictly necessary for producing jointly.

### Hypothetical Example 20

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 of Companies A and B; and
- whether competition (on price) would likely be softened in the market as a result of the joint venture.

6.100 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.

#### ***Joint tendering***

6.101 Joint tendering generally involves undertakings cooperating openly with a view to making a joint bid. Such conduct can be contrasted with bid-rigging which more often involves collusion by competing bidders which nonetheless submit separate bids. Bid-rigging is discussed at paragraphs 6.26 to 6.30 of this Guideline.

6.102 Where the joint tendering activity is carried out in the open and the arrangement is known to the party organising the tender, competition concerns may not arise at all as the arrangement may be pro-competitive.



- 6.103 In particular, the submission of a joint tender can be of benefit to competition where it allows participation by companies which would not have been able to make a stand-alone bid (i.e. the arrangement results in additional bids being made), or if it enables companies to submit more competitive bids, e.g. through a consortia arrangement.
- 6.104 For the purposes of the First Conduct Rule, joint tendering is less likely to give rise to competition concerns where the undertakings involved pool their complementary skills or different specialities. For example, the undertakings may have access to different and complementary technologies and/or the cooperation may facilitate access to raw materials, the workforce necessary for a particular project or finance.
- 6.105 Where, however, the parties could have made independent bids, the conduct may raise a concern under the First Conduct Rule. Joint tendering which leads to a reduction in the number of potential bidders is more likely to have harmful effects if there is already a limited number of potential bidders in a concentrated market.
- 6.106 Joint tendering will not generally be considered by the Commission to have the object of harming competition, rather such arrangements will be assessed for their actual or likely effects on competition in the relevant market.

### **Hypothetical Example 21**

A tender is announced for the renovation of a high-rise office building in Mong Kok. The tender requires bidders to have significant manpower to be able to complete the project in the given timeframe and also sets out a minimum financial resource threshold for the bidder – to ensure the chosen construction company has sufficient liquidity throughout the project.

Two small construction companies with a limited market share in Hong Kong, TungBuild and ChungConstruct, considered independently bidding for the tender. However, neither company had sufficient manpower resources or financial capital to satisfy the tender specifications and would thus individually be excluded from bidding.



Tung and Chung therefore submitted a joint-bid which allowed them to combine their resources to deliver the required project. The bid makes it clear they are submitting a joint tender, which transpires to be one of the lower prices submitted. Six other bids were submitted by larger construction companies who in the past five years have won the vast majority of the tenders for similar sized projects.

Assuming the creation of the TungBuild/ChungConstruct joint venture does not amount to a merger the arrangement may be assessed under the First Conduct Rule. In that regard, the joint venture does not have the object of harming competition and appears unlikely to give rise to anti-competitive effects. The fact that Tung and Chung could not individually bid for the project is particularly relevant here – they are not in fact competitors *for the project* in issue. The collaboration results in enhanced choice for the party organising the tender and a more competitive bidding process overall.

Nonetheless, Tung and Chung would need to be careful that any competitively sensitive information they share in submitting the bid and in carrying out the joint venture is used strictly for the purposes of the joint venture and that the joint venture is not used as a vehicle for exchanging commercial information on their usual prices and costs.

### ***Joint selling, distribution and marketing***

- 6.107 There exists a wide range of possible joint ventures between undertakings where they agree to jointly sell, distribute or market particular products (collectively “sales-related joint ventures”). Such arrangements range from collaboration in respect of advertising only or the joint provision of after-sales service, through to joint selling involving the joint determination of key commercial parameters including price.
- 6.108 Sales-related joint ventures can be an effective way of facilitating market entry for a new product, particularly where SMEs collaborate with a view to selling a new product they could not market individually. A sales-related joint venture does not give rise to competition concerns where the joint venture is objectively necessary for a party to enter a market it could not have entered on its own or with a smaller number of parties than those actually involved in the collaboration.

- 6.109 However, sales-related joint ventures can give rise to concerns under the First Conduct Rule where they lead to price fixing, output restriction, market sharing or the exchange of competitively sensitive information.
- 6.110 For example, agreements between competitors which are limited to the joint selling of products can serve as a vehicle for price fixing and may also entail restricting the output of the parties concerned. Where they do so, the agreements are likely to have the object of harming competition and may also be considered Serious Anti-competitive Conduct.
- 6.111 Equally, where competing undertakings enter into a reciprocal distribution arrangement with a view to limiting competition between them by allocating markets, the arrangement can be assessed as having the object of harming competition and may be considered Serious Anti-competitive Conduct.

#### **Hypothetical Example 22**

Various leading European flower producers have previously sold their products to Hong Kong through individual contracts with distributors. To rationalise their resources and reduce air freight costs, they form Bloomport JV, a joint venture arrangement under which each party agrees to make all its export sales to Hong Kong through the Bloomport brand. Bloomport will also decide on the products and volumes to be sold, the choice of customers and the prices to be charged.

The Commission would consider that this type of arrangement has the object of harming competition. By coordinating key commercial decisions, the parties risk contravening the First Conduct Rule by engaging in price fixing and output restriction.

The Commission may also consider the arrangement to be Serious Anti-competitive Conduct under the Ordinance.

- 6.112 Where sales-related joint ventures between competitors do not have the object of harming competition, they might, nonetheless, give rise to concerns under the First Conduct Rule where the relevant arrangements result in anti-competitive effects.

6.113 For example, anti-competitive effects might arise if:

- (a) the relevant arrangements increase the parties' commonality of variable costs;<sup>36</sup>
- (b) the arrangements involve the exchange of competitively sensitive information which goes beyond what might be necessary for the purposes of implementing the collaboration; and/or
- (c) in the case of reciprocal and non-reciprocal distribution agreements between competitors, the arrangement serves to undermine the incentive of one party to enter the market of another.

6.114 Even where sales-related joint ventures have the effect of harming competition, such arrangements can entail efficiencies sufficient to satisfy the terms of the exclusion for agreements enhancing overall economic efficiency in section 1 of Schedule 1 to the Ordinance. For example, this might be the case where the joint venture results in significant cost savings and synergies and/or economies of scale or scope, or improvements in product range or quality.

### Hypothetical Example 23

In order to reduce distribution costs and enhance access to a wider range of customers, a group of local microbreweries agree to set up a single distribution and delivery centre. Each of the breweries contributes their existing delivery staff and vehicles to the centre.

An arrangement of this kind would be unlikely to give rise to concerns under the First Conduct Rule. The scope of the cooperation is limited to one discrete aspect of the commercial activities of the parties and seems unlikely to require the parties to share competitively sensitive information, beyond the identity of customers which in any event is necessary for the purposes of implementing the collaboration. In particular, the parties remain free to set their own prices. Furthermore, although the parties transport costs might be harmonised by the arrangement, other significant input costs (e.g. ingredients, brand investment, marketing, and production) will continue to vary across the breweries and there remains ample room for competition on product quality.

<sup>36</sup> See footnote 28 above.

## Franchise Arrangements

- 6.115 Franchise arrangements are a common business model for the production and distribution of products in Hong Kong.
- 6.116 With limited investment and risk, franchise agreements permit franchisors to quickly establish a network of entities with a uniform brand image and consistent product offering. Franchise agreements also allow franchisees with limited resources to benefit from the reputation and support services of a more widely known brand.
- 6.117 Measures necessary for maintaining the identity and reputation of a franchise network and/or provisions of a franchise agreement which are essential to protect the franchisor's branding, trademarks and know-how do not raise concerns under the First Conduct Rule. Other restrictions in a franchise agreement may contravene the First Conduct Rule where they have the object or effect of harming competition.

### *Maintaining the identity and reputation of the franchise network*

- 6.118 A franchise agreement may contain restrictions with the objective of maintaining the identity and reputation of the franchise network. These may include the following obligations on the franchisee:
- (a) to apply the business method developed by the franchisor;
  - (b) not to use the franchisor's trademarks, trade names or other marks anywhere other than at the agreed franchise location;
  - (c) to exploit the franchise from the agreed location and not to change location without consent of the franchisor;
  - (d) in certain circumstances, not to sell competing goods apart from those supplied by or selected by the franchisor;
  - (e) to only sell products in a manner consistent with instructions of the franchisor (e.g. following a particular recipe, using particular technology, sales methods/promotional material); or
  - (f) to decorate the franchise premises in a manner specified by the franchisor.
- 6.119 Although restrictions of the above kind limit a franchisee's commercial freedom, they will not give rise to concerns under the First Conduct Rule where they relate directly to and are necessary for the implementation of the franchise arrangement.<sup>37</sup>

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<sup>37</sup> Restrictions which are necessary for some other commercial arrangement (ancillary restrictions) are discussed at paragraphs 3.28 to 3.33 of this Guideline.

### ***Protecting the franchisor's branding and know-how***

6.120 A franchise agreement may contain provisions that legitimately protect the franchisor's know-how and expertise. These may include, for example, a restriction on the transfer of the franchise, requirements on the use of the franchisor's intellectual property or obligations in relation to protecting confidential information and know-how, a prohibition during the term of the franchising contract on opening the same kind of shop in an area where it might compete with another franchisee or on carrying on any kind of competing business, and/or a prohibition for a reasonable period after the termination of the franchise on opening the same kind of shop in an area where it might compete with another franchisee. Such aspects of a franchise agreement are inherent in the nature of franchising (i.e. the relevant restrictions are ancillary to a legitimate commercial purpose) and, as such, typically raise no concerns under the First Conduct Rule.

### **Selective Distribution**

6.121 Some businesses sell their products to end consumers through a network of authorised retailers chosen on the basis of particular criteria. Generally, the suppliers will prevent the authorised retailers from reselling the products concerned to non-authorised retailers.

6.122 Selective distribution systems are a common feature of the market in Hong Kong, particularly as regards the sale of branded final products. Selective distribution is very often economically beneficial and an effective way of furthering inter-brand competition. In particular, selective distribution may assist in establishing a quality reputation for a new product, can incentivise retailers to increase marketing efforts and might serve to maintain brand image and quality standards.

### ***Qualitative criteria for establishing a selective distribution system***

6.123 Generally, where a supplier selects retailers on the basis of purely qualitative criteria<sup>38</sup>, the arrangement will not give rise to concerns under the First Conduct Rule where the following conditions apply:

- (a) the nature of the product is such as to require a selective distribution network in order to preserve its quality and ensure its proper use;

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<sup>38</sup> The following criteria might be regarded as examples of qualitative criteria: criteria relating to the training or qualifications required of staff; criteria relating to the type of equipment available on the premises of the retail outlet; a stipulation that the products be sold in a specialist shop or that there be a separate display for the products; criteria requiring sales outlets to have a certain appearance; stipulating particular opening hours; or requiring the provision of after sales services.

- (b) members of the network (the authorised retailers) are selected on the basis of non-discriminatory qualitative criteria relating to their technical ability to handle the product or the suitability of their premises to protect the brand image of the product; and
- (c) the relevant criteria do not go beyond what is necessary for the particular product concerned.

6.124 Where the selective distribution system does not have the above characteristics, the Commission may need to assess the effects of the arrangement on competition. In this context, the Commission may consider, for example, whether the arrangement:

- (a) leads to anti-competitive foreclosure at the distributor/retailer level; and/or
- (b) serves to facilitate collusion between suppliers or distributors/retailers.

6.125 Risks to competition may be more likely when the supplier has market power, where the number of authorised retailers is small and/or all major competing suppliers in the market have similar selective distribution methods.

#### ***Other conditions in a selective distribution system***

6.126 Some selective distribution systems select retailers on quantitative criteria e.g. sales targets or a pre-defined number of retailers in a particular locality. In addition, selective distribution systems may contain restrictions that do not relate to the qualitative needs of the supplier. For example, retailers may be prevented from making cross-sales to other members of the system, or selling to customers outside a prescribed class of customers. Such arrangements may give rise to concerns under the First Conduct Rule on the basis of their effects on competition.

6.127 In assessing the effects of such arrangements, the Commission will consider the market power of the supplier. Selective distribution systems are more likely to cause concern where inter-brand competition is limited and the supplier's market position is particularly strong. In addition, where there is widescale use of selective distribution in the relevant market, the risks of foreclosing certain types of retailer (e.g. more efficient retailers or "price discounters") and collusion between the major suppliers (i.e. competing brands) are more likely to arise.

# Annex

## Exclusions and Exemptions from the First Conduct Rule

### I Introduction

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- 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. Undertakings can assess for themselves whether their conduct falls within the terms of a particular exclusion or exemption. Equally, undertakings may assert the benefit of an exclusion or exemption as a defence in any proceedings before the 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.
- 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.

- 1.6 Schedule I to the Ordinance provides for the following general exclusions in respect of the First Conduct Rule:
- (a) agreements enhancing overall economic efficiency;
  - (b) compliance with legal requirements;
  - (c) services of general economic interest;
  - (d) mergers; and
  - (e) agreements of lesser significance.
- 1.7 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 Section I of Schedule I provides for a general exclusion on the ground that an agreement enhances overall economic efficiency (the “**efficiency exclusion**”).
- 2.2 Section I of Schedule I only applies where certain cumulative conditions are met, namely where the relevant agreement:
- “(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 efficiency exclusion is available whether the agreement has the object or the effect of harming competition.



- 2.4 Where an agreement has the object or effect of harming competition contrary to the First Conduct Rule, the parties to the agreement may rely on the efficiency exclusion 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 seeking the benefit of the exclusion.
- 2.5 The efficiency exclusion applies when four separate conditions are met.

### **First condition**

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

- 2.6 The application of the efficiency exclusion requires an assessment of the claimed contribution of the agreement to “improving production or distribution” or “promoting technical or economic progress”. The term “efficiencies” as used in this Guideline refers to the claimed contributions to improving production or distribution or promoting technical or economic progress.
- 2.7 An undertaking relying on the efficiency exclusion must provide convincing evidence of each of the following:
- (a) the efficiencies, which must be objective in nature;
  - (b) a direct causal link between the efficiencies and the agreement;
  - (c) the likelihood and magnitude of each efficiency;
  - (d) how each efficiency will be achieved; and
  - (e) when the efficiencies will be achieved.
- 2.8 The efficiencies referred to in the efficiency exclusion cover all objective economic efficiencies, including cost efficiencies and qualitative efficiencies.
- 2.9 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).

- 2.10 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.
- 2.11 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 methods of production or distribution; improvements in product quality; or increases in the range of products produced.
- 2.12 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.

## **Second condition**

### ***Consumers receive a fair share of the efficiencies***

- 2.13 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.
- 2.14 Undertakings seeking to invoke the efficiencies exclusion in respect of a particular agreement must demonstrate that consumers receive or will receive a fair share of the efficiencies generated by the agreement.
- 2.15 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. The key consideration 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*

- 2.16 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 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.
- 2.17 This third condition implies that as regards the agreement there be no other economically practicable and less restrictive means of achieving the efficiencies.<sup>39</sup> 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 24**

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.

<sup>39</sup> The market conditions and business realities facing the parties should be taken into account in this context.

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 exceeds 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.

#### **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***

- 2.18 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 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.
- 2.19 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.
- 2.20 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 must be considered. In this context, the parties will need to do more than merely assert that barriers to entry are low.

2.21 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. If 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 25**

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 agree to coordinate their schedules and certain of their tariffs on the route in the context of a codeshare arrangement. Following the 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. 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.

### 3 Compliance with Legal Requirements

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- 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<sup>40</sup> or imposed by any national law<sup>41</sup> 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.
- 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

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- 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<sup>42</sup> 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.

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<sup>40</sup> 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.

<sup>41</sup> Section 3 of the Interpretation Ordinance provides that the term “national law applying in Hong Kong” means a national law applied in Hong Kong pursuant to the provisions of Article 18 of the Basic Law.

<sup>42</sup> 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.

- 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.
- 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 products 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.<sup>43</sup> 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.

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<sup>43</sup> The concept of a service of general economic interest might be seen as loosely corresponding to the concept of a public service.

- 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 at 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 must also show that the entrusted tasks could not be discharged in other ways, which would cause less harm to competition.

## **5 Mergers**

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- 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 further discussed in Part 6 of this Guideline.

## **6 Agreements of Lesser Significance**

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- 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<sup>44</sup> 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.
- 6.2 As stated at section 5(5) of Schedule 1 to the Ordinance, 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.

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<sup>44</sup> 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 are contained in regulations made by the Secretary for Commerce and Economic Development under section 163(2) of the Ordinance. The relevant regulations are available on the Commission's website.

- 6.3 The general exclusion for agreements of lesser significance is not available if the agreement is considered Serious Anti-competitive Conduct under the Ordinance.
- 6.4 Additional rules in respect of the calculation of relevant turnover of an undertaking for the purposes of this particular general exclusion are contained in regulations made by the Secretary for Commerce and Economic Development under section 163(2) of the Ordinance.<sup>45</sup>

## 7 Block Exemption Orders

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- 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.<sup>46</sup>
- 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

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- 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 that directly or indirectly relate to Hong Kong ("**International Obligations Exemption**").<sup>47</sup>

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<sup>45</sup> The relevant regulations are available on the Commission's website.

<sup>46</sup> 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*.

<sup>47</sup> 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".

- 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 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, Specified Persons and Activities**

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- 9.1 Section 3 of the Ordinance provides that the First Conduct Rule does not apply to statutory bodies.<sup>48</sup> 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.<sup>49</sup> 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.

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<sup>48</sup> 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)".

<sup>49</sup> 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).

- 9.3 Section 4 of the Ordinance provides that the competition rules (including the First Conduct Rule) do not apply to persons specified in a regulation made by the Chief Executive in Council under section 5 of the Ordinance or to persons engaged in activities specified in such a regulation. The reference to a person in section 4 of the Ordinance includes an employee or agent of the person acting in that capacity.
- 9.4 All regulations that might be made by the Chief Executive in Council under section 5 of the Ordinance will be available on the Commission's website.

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