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Managing Distribution and Compliance in China: Post the Auto Antitrust Guidelines

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In September 2020, China's central antitrust enforcement authority, the State Administration for Market Regulation ("SAMR"), released four antitrust guidance documents all at once, one of which is the long expected *Antitrust Guidelines on the Automotive Industry* ("Auto Guidelines"). Four years have passed since the draft for public solicitation. During this period the authorities never ceased their enforcement activities in the auto sector, and the accumulated fines have approached CNY2.6 billion in total. Now, the Auto Guidelines indicate that the automotive industry will remain a priority for antitrust enforcement, and can expect more transparent and predictable enforcement approaches.

The potential impact of the Auto Guidelines would be wide-ranging. Following the basic structure of the *Anti-Monopoly Law* ("AML"), SAMR further analyses industry-specific issues in each chapter of this document. Not only are some enforcement-focused behaviors addressed in detail, such as resale price maintenance ("RPM"), but also the enforcement gap in China, such as non-pricing vertical restraints, is elaborated. The analytical roadmap provided therein could affect industries other than the automotive industry and, in this way, SAMR provides stakeholders with very detailed and comprehensive compliance guidance. This article summarizes the key aspects of the Auto Guidelines and related compliance suggestions.

I. Overview

A. Role of the Auto Guidelines in Light of Antitrust Enforcement

In the strictest sense, as indicated by its name ("guideline"), the Auto Guidelines is not a law or regulation in China. It was issued in the name of the State Council Anti-Monopoly Committee, which is a coordinating agency with its standing office set within SAMR. Therefore, the Auto Guidelines could be seen as the SAMR's interpretation of the AML, manifesting the SAMR's views on specific behaviors. Consequently, it shouldn't be read as anything less than a binding rule.

Being the first sector-specific antitrust guideline issued by SAMR, the Auto Guidelines goes beyond its specific sector. As explained, it reflects to a greater extent the enforcer's attitudes and clarifies some practical issues, particularly those regarding vertical restraints, which sheds light on similar topics for other sectors. A thorough understanding of the enforcement approaches and standards will therefore help undertakings from all industries to adjust their commercial strategies and business procedures in a timely manner in order to reduce potential legal risks and compliance costs.

B. Roadmap for Regulating Vertical Restraints

The Auto Guidelines reaffirm SAMR's current enforcement practices regarding vertical restraints – i.e. "prohibition plus exemption." Article 14 of the AML prohibits fixing resale prices or restricting minimum resale prices (collectively referred to as RPM), as well as other kinds of vertical restraints under a catch-all provision. Vertical restraints are therefore prohibited unless exemptions can be applied pursuant to Article 15 of the AML.

The Auto Guidelines specify that exemptions include both presumed exemptions and case-by-case exemptions. Presumed exemptions can apply to territorial restrictions and customer restrictions set by an undertaking without significant market power – similar to safe harbor rules in the EU. Exemptions of other restrictions have to follow case-by-case application

according to Article 15 of the AML, and the Auto Guidelines provide some scenarios in which such exemptions might be plausible. Details of relevant provisions will be explained in the ensuing parts.

When an undertaking has dominant market position, imposing vertical restraints may well constitute an abuse of dominant position pursuant to Article 17 of the AML. In addition, the Auto Guidelines suggest the possibility of defining a single brand as a relevant market in aftersales. Consequently, an undertaking without a dominant market position in the new car sales market may be found dominant in the relevant market of its own aftermarket, which amplifies the antitrust risks of its restrictions in the aftermarket.

II. RPM: Still at High-Risk Level

A. Public Enforcement Priority and the Difference from Judicial Standards

For years, RPM has been an enforcement priority in China for authorities of different levels. Most recently, the Jiangsu Administration for Market Regulation imposed a fine of more than CNY87 million on Toyota China for RPM. Toyota China has required Lexus dealers in Jiangsu Province not to make an offer on online platforms with a price lower than its recommended resale price, and set a cap on their discount rate. These RPM behaviors were implemented through checking dealers' invoices and threatening non-compliant dealers with cutting supplies in the future. It is a common form of RPM in China – recommended price with carrots and sticks – and enforcement against it shows that RPM remains on the authorities' radar.

1. The Approach of Public Enforcement: Per Se Violations

SAMR and local market regulators, like their predecessors before the institutional reform of antitrust enforcers, persist in the traditional 'illegal *per se'* rule. It means that they can investigate and penalize RPM behavior without an in-depth analysis of its impact on market competition. The Auto Guidelines affirm this position by stating that RPM is explicitly prohibited by the AML, and its negative effects mainly include maintaining high prices, facilitating horizontal collusion, weakening inter-brand and intra-brand competition, and blocking competitors. The burden should be shifted to the undertaking to prove that RPM will not seriously restrict market competition and consumers can benefit therefrom, if the undertaking hopes to apply for a case-by-case exemption.

In addition, and in line with its enforcement practices, SAMR specifically restates in the Auto Guidelines that RPM behaviors include not only direct and indirect RPM but also those in disguised forms. The proposal of recommended price, guide price or even maximum resale price, when implemented together with reward or punishment and resulting in such prices being mostly if not strictly followed by distributors, may also be considered as RPM.

2. The Rule of Reason in Civil Disputes and the Yutai Case Affirming Divergence

While SAMR is sticking to the rigorous *per se* rule, China's courts are taking a different approach in private litigations – akin to the rule of reason in the US. It means that they will examine both pro- and anti-competitive effects of the suspected RPM agreement, and plaintiffs have the relatively high burden of proof to demonstrate anti-competitive effects. The

bifurcated standards adopted by judicial and administrative authorities are confirmed by the Supreme People's Court ("SPC") in the renowned *Yutai* case.

Yutai is a fish feed products company and was fined for RPM by a local antitrust authority. Following the penalty decision, Yutai brought an antitrust administrative case against the authority to challenge the decision and won the first-instance trial, where the local court ruled that the authority had failed to prove anti-competitive effects. However, at second-instance and then at the SPC's retrial in December 2018, the authority finally won. The SPC recognized that antitrust authorities do not need to prove anti-competitive effects in their public enforcement considering the current political and economic context of China.

The SPC reasoned that the requirements of strict economic analysis of competitive effects have more cons than pros and, given the immature and developing stage of market conditions and enforcement practices in China, such requirements will significantly increase enforcement costs and reduce enforcement efficiency. Meanwhile, the SPC held that for plaintiffs in civil disputes, anti-competitive effects have to be proven in order to claim compensatory damages. The decision implies that after *Yutai*, the courts and antitrust authorities may keep using different approaches towards RPM in China.

B. Potential Exemptions Provided

As explained, the antitrust enforcement authorities still take the illegal *per se* view against RPM and the only viable option for undertakings is to apply for case-by-case exemptions in accordance with Article 15 of the AML. Article 15 of AML provides that Articles 13 and 14 will not be applicable to agreements between undertakings which can be proven to have been concluded for one of the enumerated pro-competitive purposes, such as promoting R&D or increasing efficiency, etc., if they can also prove that the agreements will not seriously restrict market competition, and consumers can benefit from them. The Auto Guidelines list four examples of exemptions – four scenarios in which market competition may not be severely impaired and consumers may benefit from such conducts. In practice, these scenarios may have broader application scope and shed light for other industries as well.

1. Middleman/E-platform Exemption

The middleman exemption refers to the scenario where RPM is imposed on a distributor who acts as a middleman and simply fulfills the duties of delivery, collection of payment and provision of invoices, etc. Similarly, the e-platform exemption deals with the scenario where the supplier sets a fixed price for a given period and trades with unspecified final users through e-platforms, and the distributor simply fulfills the duties of delivery, collection of payment and provision of invoices, etc.

In both scenarios, the actual role of the distributor differs from that of a traditional distributor, who undertakes risks at its own cost. The rationale behind this is comparable to the agency agreement, which under EU competition law falls outside of Article 101(1) of the *Treaty on the Functioning of the European Union*.

2. Short-term Exemption for Promoting NEVs

The Auto Guidelines also exempt short-term RPM set for new energy vehicles ("NEVs"), in order to promote the sale of NEVs and to prevent service free-riding. The exemption term is clearly provided for as long as nine months, counting from the date when the first wholesale

invoice is issued. In addition, the Auto Guidelines leave some space for flexibility by emphasizing that such a period might be adjusted according to relevant industrial and technological developments.

Though the exemption for NEVs appears to be quite sector-specific, businesses in other industries may consider this channel if they hope to adopt RPM when introducing new products to the market. But surely other elements of Article 15 also have to be satisfied when taking advantage of this exemption, so that competition in the relevant market won't be severely restricted and consumers can share in the benefits.

3. *Exemptions in Public Procurement*

Another scenario involves government procurement. As a common practice in the automotive industry, auto suppliers are often required to reach a consensus with their distributors before submitting their joint bidding price. Or sometimes, the government may reach an agreement with a supplier directly and the supplier may have to seek the cooperation of its distributors to attend procurement proceedings due to qualification restrictions. In that case, the distributor, again, assumes a mere assisting role.

C. Compliance Suggestions

For RPM, the Auto Guidelines unambiguously indicate the high level of risk and SAMR's rigorous enforcement approach. But the good news is that they also provide specific scenarios of exemptions that companies can turn to. In the RPM compliance of undertakings, it is suggested that the legal team could help the business team assess and determine an undertaking's relationship with distributors and with end customers, and what roles the so-called "distributors" really take, which would be a fact-intensive analysis. If a distributor is only fulfilling the functions of delivering, collecting payment, or billing, it is possible to obtain an exemption. Promoting new products might be another option, provided that RPM behavior won't last long. Accordingly, the contracts and relevant records should be modified to reflect that the elements for exemptions pursuant to Article 15 of the AML are met.

III. Unfolding the Rules on Vertical Non-Price Restraints

A. Explaining the Enforcement Gap and Putting Forward the General Approach

In China, the antitrust enforcement authorities have never penalized any pure, vertical non-price restraint, though it might constitute a vertical monopoly agreement under the catch-all provision of Article 14 of the AML. There are many reasons for such a situation. One is that, unlike the *per se* approach against vertical price restraints, for vertical non-price restraint cases it is the authorities who have the burden of proving anti-competitive effects. Also, in the pre-SAMR era, two agencies divided the power of enforcement against monopolistic conducts among themselves: the State Administration for Industry and Commerce ("SAIC") is responsible for non-price restraints, and the National Development and Reform Commission ("NDRC") is responsible for the price-related ones. Therefore, in cases like *Medtronic*, although NDRC rightfully pointed out the anti-competitive effects of the non-price restraints, the scope of its powers required it to make decisions based on the price-related conducts.

Such a situation is expected to change with the establishment of SAMR, and the elaboration in the Auto Guidelines might well be a signal of it. More specifically, the Auto Guidelines recognize the pro-competitive effects of vertical non-price restraints in certain scenarios, and therefore creates a safe harbor for specific behaviors based on market share. However, it also enumerates certain conducts that it considers could usually impair competition, increase prices, and reduce customers' choices, where exemptions have to be applied on a case-by-case basis.

B. Territorial/Customer Allocation: Safe Harbor + Hardcore Restrictions

According to the Auto Guidelines, territorial and customer allocations set by undertakings with insignificant market power – a share of less than 30 percent – are likely to lead to economic efficiency, such as protecting brand-specific investment, and therefore might be presumably exempted under Article 15 of the AML. In the draft of the Auto Guidelines that was released in 2016 to solicit public comments, the original safe harbor adopted was a range of between 25 and 30 percent. The adoption of a fixed percentage answers public concerns and provides more certainty and transparency for future enforcement.

The Auto Guidelines specify the following territorial/customer allocations by undertakings who fall within the safe harbor to be exemptible:

1) requiring a distributor to only operate within its business premise, without restricting passive sales by the distributor nor cross-supply among authorized distributors (passive sales refer to sales by a distributor in response to unsolicited orders from outside the allocated sales territory of the distributor);
2) restricting a distributor from active sales in the exclusive territory or exclusive customers reserved by the auto supplier for another distributor;
3) restricting direct sales by wholesalers to end users;
4) restricting a distributor from selling parts to customers, to avoid parts being used by such customers to produce the same products as the auto suppliers.

Restraints on passive sales, cross-supply among authorized distributors, and sales of auto parts to end users for maintenance by distributors and maintenance service providers, are strictly prohibited – these are the core restrictions. Such restraints cannot benefit from safe harbor rules, though a case-by-case exemption might be possible in theory, and thus involves much greater risks than ordinary territorial/customer allocations.

C. Other Types of Vertical Non-Price Restraints

In addition to territorial and customer allocations, the Auto Guidelines also list other types of vertical non-price restraints. It regards the after-sales maintenance services and the sales of components and parts through warranty clauses as unreasonable indirect vertical restrictions, which include but are not limited to:

1) requiring end users to employ authorized maintenance providers for the maintenance work that falls outside the scope of the warranty as a condition of fulfilling warranty claims;

2) requiring the use of original components and parts for the maintenance work that falls outside the scope of the warranty as a condition of fulfilling warranty claims;
3) restricting service providers from providing maintenance services to parallel import cars without justification.

The Auto Guidelines additionally list some conducts that might also be treated as vertical non-price restraints. To name a few here: tying unwanted vehicles, parts, consumables, maintenance tools, instruments, etc.; imposing unreasonable sales targets, quantities, or variety of inventory on distributors; forcing distributors to cover the cost for promotion carried in the name of the suppliers, or restricting advertising methods or media carried out at the expense of distributors; restricting the choice of vendors for distributors and maintenance service providers with regards to office facilities, business premise design, etc; refusing to deal if distributors and maintenance service providers engage in pro-competitive conducts against the supplier's will.

Besides, compared to the draft, the Auto Guidelines add a new provision regarding single branding. According to the Auto Guidelines, an auto supplier can make the necessary agreements or propose necessary service standards for distributors to market its products, and provide relevant training and guidance. However, prohibiting distributors from representing other suppliers or selling products from other companies or brands on their business premises may create barriers for new or existing competitors in terms of circulation channels, and therefore restrict competition. Nevertheless, a supplier is allowed to require a separate marketing area for its own products.

D. Relationship between Vertical Monopoly Agreements and Abuse of Dominance

The AML also prohibits undertakings with dominant market positions from abusing such dominance. Therefore, the vertical restraints listed above, if carried out by an undertaking with a dominant market position, will also incur risks of charges of abuse of dominance. The determination of abusive conducts is conditioned upon holding a dominant market position, and in China a market share of more than 50 percent creates the presumption of dominant position. Therefore, risk analysis of such restraints relates closely to the market power of an undertaking: vertical restraints with a share of more than 50 percent may trigger abuse of dominance, and those imposed by undertakings fall under such presumptive thresholds should be examined under Article 14 and Article 15 of the AML. Such a position is confirmed by the Auto Guidelines.

E. Compliance Suggestions

The Auto Guidelines are extremely helpful in compliance with regards to vertical non-price restraint because of the analysis roadmap and the examples of conducts provided in it, particularly against the backdrop of the enforcement gap in China. The safe harbor rules on territorial/customer allocations create certainty for undertakings without significant market power while indicating risks for undertakings having significant market power or trying to impose core restrictions. Again, this should not be confined to the auto sector only. For other listed behaviors, the Auto Guidelines make explicit where their pro-competitive effects may lie, and thus gives undertakings an opportunity to make a self-assessment of the conduct at issue.

IV. Aftermarket Management

A. Potential for Defining a Single Brand as a Relevant Market

Consistent with the *Guidelines on the Definition of Relevant Market* also issued by the State Council Anti-Monopoly Committee, the Auto Guidelines follows the standard approach of substitutability analysis. It mentions that in some cases, the wholesale market and the retail market of automobiles may be two separate markets.

In addition, the Auto Guidelines mention the possibility of separately defining an aftersales market, which may be further divided into an auto parts sales market and a maintenance service market. Worth mentioning is that the Auto Guidelines stress that, unlike the new car sales market which is relatively competitive, conducts with adverse effects are more commonly seen in the aftermarket due to lock-in effects and compatibility issues. An undertaking without dominant market position in the new car sales market may be found to be dominant in the relevant market of its own aftermarket.

As for the geographic market, the Auto Guidelines take passenger cars as an example and suggest that the manufacturing and wholesale markets may be nationwide, while the retail market can be defined as a provincial or regional market based on actual conditions.

B. Vertical Restraints in the Aftermarket

The third section above has already given some examples of vertical restraints that relate to the aftermarket, e.g. preconditioning the fulfilling of warranty claims with restrictions on purchasing options for maintenance outside the scope of the warranty. Given the possibility of defining a single brand as a relevant market, the Auto Guidelines set forth the following scenarios that may present risks of dominance abuse:

1) Auto suppliers with a dominant position shall not restrict components and parts suppliers from producing dual-branded parts, unless otherwise justified, as it will prevent components and parts suppliers from manufacturing products of the same quality with their own brands, limit customer choices, and reduce competition;

2) Auto suppliers with a dominant position shall not restrict the circulation of components and parts by restricting the purchase of products of the same quality, transactions via other channels (including parallel imports), or sales of components and parts to others by suppliers, distributors, or maintenance service providers, unless otherwise justified;

3) Auto suppliers, as sole provider of a vehicle’s maintenance technical information, shall not limit the availability of such information, the testing equipment, and maintenance tools by setting excessive market prices or restricting the sale and provision of relevant products or information, unless otherwise justified.

C. Compliance Suggestions

The Auto Guidelines signal to the risks of defining a single brand as a relevant market, which will make restrictions in aftermarkets fall afoul of Article 17 – abuse of dominant market position – more easily. In China, a single brand as a relevant market has not been formally applied in public enforcement cases. However, there has been a civil dispute in which private litigants tried to advocate in favor of such a theory. In the *Hankook* case, a distributor put

forward that Hankook branded tires constituted an independent relevant market, but the theory was ultimately dismissed by the presiding court. Nevertheless, such risks as echoed by the Auto Guidelines should not be overlooked by car suppliers or major suppliers in other industries with similar lock-in effects.

V. Conclusion and Looking Forward

It is expected that the Auto Guidelines will have significant impact in both the automotive industry as well as all other industries in the post-SAMR era. Undertakings are recommended to adjust their current compliance procedures and business operation accordingly. First, it is of crucial importance for undertakings to identify the relevant product markets and geographic markets that they participate in. For suppliers in the automotive industry or other industries that share the same characteristics, additional attention should be given to the aftermarket, where they may be considered dominant if it alone constitutes a relevant market. When applying price-related restraints in distribution management, the undertaking should carefully explore the potential methods taken. Although the Auto Guidelines have mentioned the possibility of exemptions, undertakings must strictly satisfy all elements under Article 15. As for other vertical non-price restraints, it is advised to adopt restraints with justifiable reasons or pro-competitive arguments, so that associated risks would be reduced.

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