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China Releases New Rules Guiding Merger Control Review

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Background

The Anti-Monopoly Law ("AML") opens a new landscape for merger and acquisition practice in China. Regardless where a merger takes place, if the transaction satisfies the prescribed conditions, it must be filed with China's Ministry of Commerce ("MOFCOM"), the agency charged with enforcing the merger control laws in China, for business concentration review. If the merger is found to cause or likely to cause any effect of eliminating or restricting competition in the Chinese market, MOFCOM may either reject the deal or approve it with specific restrictive conditions with a view to alleviating such effects.

To date, MOFCOM has published eight business concentration decisions, including one rejection and seven conditional approvals (i.e. InBev/Anheuser Busch, Coca Cola/Huiyuan, GM/Delphi, Mitsubishi Rayon/Lucite, Pfizer/Wyeth, Novartis AG/Alcon, and Sanyo/Panasonic, Uralkali/Silvinit). The State Council and MOFCOM have also promulgated a number of regulations to clarify some key implementation issues regarding the review regime, including Provisions on Pre-Concentration Reporting Criteria, Guidelines on Relevant Market Definition, the Measures for Reporting of Concentration of Business Operators, the Measures for Review of Concentration of Business Operators, etc. The basic filing and review procedures prescribed in these regulations enable MOFCOM to accept and process the review applications. However, there is yet any official guidance on how to assess competitive effect of a merger.

Recently, MOFCOM has published a new draft regulation, the Provisional Measures on Assessment of Competitive Effects of Concentration of Business Operators (the "Provisional Measures"). The Provisional Measures outline the basic principles and methodologies for assessing competitive effect of a merger. It reflects MOFCOM's effort, after having gained some experience in this area, to make its review process more transparent, as the agency is keen to exert greater influence on international transactions. Unfortunately, due to the limited practice in China, the Provisional Measures are sparse of details comparing to the rules applied in the more matured antitrust jurisdictions like the US and EU.

Factors to Consider in a Merger Control Review

The factors to consider in a merger review have all been listed in Article 27 of the AML. Such factors include:-

1. Market share of the business concentration participant in the relevant market and the power of control in the market;
2. Concentration in the relevant market;
3. Effect of the concentration on market entrance and innovation;
4. Effect of the concentration on competitors and consumers;
5. Effect of the concentration on national economy; and
6. Other factors the anti-monopoly enforcement authority may consider relevant.

The entire list is prescribed in the Provisional Measures without significant change. The Provisional Measures clarify that MOFCOM shall synthetically take into account these factors when conducting an individual review. The weight to be given to each of the factors, however, is determined in accordance with the particularities of each merger transaction. The factors 1 to 4 are widely-accepted antitrust factors, but national economy and other factors may be in place to accomodate the non-antitrust factors in order to give the review more space of maneuverability. The Provisional Measures provide a few examples to non-antitrust factors to be considered. Such factors include public interest, market efficiency, whether any merger participant concerned is on the brink of bankruptcy, etc. There apparently is no clear end in the list of considerations.

The practice of MOFCOM in the past is consistent with the above. In all the announced decisions (except that of the *InBev/Anheuser case* where MOFCOM did not specify the factors it considered), MOFCOM expressly claimed that it had considered all the above factors 1 to 5 in making the decisions. In three decisions so far, MOFCOM claimed that it had taken into account other factors it deemed relevant. For example, in the *Coca Cola/Huiyuan* Case, the only deal so far that has been rejected for potential adverse competitive effect, MOFCOM took into account the harm the merger could have caused to China's domestic small and medium-sized manufacturers and the healthy development of the Chinese fruit-juice drink industry. In the *Uralkali/Silvinit Case* where a conditional approval was granted, MOFCOM sheds light on the consideration of national economy as a relevant factor. In the case, the potential adverse impact of the merger of the two entities on China's agriculture and the industries related to agriculture was referred to as a relevant consideration in MOFCOM's decision. Although the underlying analysis and reasoning leading to the relevance of this factor are not explicated, MOFCOM's concern possibilly was the effect of the merger on the supply stability and price of the products in the Chinese agriculture, which has long been considered as a key sector in China's national economy with significant bearing even on national security.

The Provisional Measures further explain MOFCOM's approach in assessing the competitive effect of a merger. MOFCOM must firstly consider whether the merger will likely enhance the capability of a single operator of eliminating or restricting competition in the relevant market, or such capacity of all the controlling operators when the relevant market is controlled by multiple participants. If the existing operations or potential operations of the parties to a merger are not in one defined relevant market, MOFCOM must consider the competitive effect of the merger in the upstream and downstream markets or any related markets.

Market Shares

Market share is one of the most important factors for assessing competitive effect of a merger. The Provisional Measures provide a basic definition of market share and list the issues to consider when evaluating the control of a market participant in the relevant market. The regulation also briefly addresses the implications of market share to the competitive effect of a merger. According to the Provisional Measures, market share is the portion of the services and products provided by a business operator in the relevant market within a defined period of time. It is a direct indicator of both the structure of concentration of a given market and the status of the business operators concerned in the market.

To measure the control strength of a merger participant in the relevant market, the Provisional Measures set out a list of factors to be considered. Among others, a number of circumstances in Article 18 of the AML, which describe the legal basis for determing dominant position of a business operator, are quoted in the Provisional Measures for measuring the control. In specific, the circumstances include the following:

1. The market shares of the concentration participants and the market concentration condition;
2. The substitutability of the services or products offered by the concentration participants;
3. The production capability of the business operators not participating in the concentration in the relevant market;
4. The capability of the concentration participants of controlling the upstream or downstream markets;
5. The capability of the buyer in the concentration participants in changing its suppliers;
6. The financial and technical ability of the concentration participants;
7. The purchase power of the downstream customers of the concentration participants;
8. Other circumstances to be considered.

The Provisional Measures are lack of some essential implementing details, such as the approach of calculating market share, the evidence required for determining market shares, consideration of various distorting factors in some special market, etc.

In all the announced decisions, MOFCOM tends to relying on both the pre-merger and post-merger market shares of a relevant party to determine the party's influence in the market and the likelihood of anticompetitive effect. The post-merger market share of the merger entity is often considered together with other factors, such as the next competitor's market share, when assessing the change the proposed merger would bring to the market. In some early cases, the market share data were not specified in MOFCOM’s decisions. From the *Pfizer/Wyeth Case*, MOFCOM starts specifying the market share data on which it relies to make a decision. However, due to different market definitions in each case and lack of calculation details, the practice looks divergent.

In the *Pfizer/Wyeth Case*, for instance, swine mycoplasmal pneumonia and some other vaccines were defined as the product market and China was defined as the geographic market. MOFCOM found that the merged entity would have a combined market share of 49.4% in the market, which is significantly higher than that of the next competitor in the market, Intervet, holding 18.35% of the market and other competitors, of which each holds less than 10%. MOFCOM determined therefore that the merger would cause substantial change in the product market, and would have allowed the merger firm with such an advantageous market position to expand its market share and further exercise anti-competition control on price.

In the *Sanyo/Panasonic Case*, the merger participants and their affiliates were found dominating several product markets. MOFCOM found that the merger, if implemented, would have given its participants and relevant affiliates a market share of 46.4% for rechargeable portable nickel metal hydride batteries, 61.6% for coin-shaped rechargeable lithium batteries, and 77% for rechargeable nickel metal-hydride batteries for automotive use. The merger entity would be able to enjoy high market shares in different product lines, far exceeding the next competitor. The high market share of the merger firm would also restrict the downstream buyer’s right of choosing suppliers and possibly reduce significant number of producers in the same business.

In the *Uralkali/Silvinit Case*, MOFCOM found that the two undertakings, after merger, would account for over 1/3 of global market share and become the second largest supplier of potassium chloride. It also found that almost half of the Chinese demands for potassium chloride are met by imports and almost half of the Chinese imports are from the merger parties and their associated traders. Having considered the high global market share and the dependence of the Chinese buyers on the merger participants, MOFCOM determined that the merger would increase the level of market concentration by reducing the number of competitors, and therefore facilitate the global suppliers to coordinate their activities, which would eventually harm the interest of the buyer.

In the *GM/Delphi Case,* MOFCOM was concerned about the alignment of interest between the merger participants as a result of the merger, due to the "leading position of GM in the Chinese market" and "the leading position of Delphi in the global part market and the prospect of growth in the Chinese market". Although the market shares of the parties were not specified, they played an important role in MOFCOM's decision.

Level of Market Concentration

The level of market concentration is another factor important to determine the competitive effect of a merger. Market concentration is often calculated by the Herfindahl - Hirschman Index ("HHI") and the Concentration Ratio Index of the leading n business operators in terms of business revenues ("CRn"). The HHI is calculated by squaring the market share of each firm competing in the market and then summing the results. The CRn is calculated by aggregating the market shares of the numbers of firms in the market. The values of these indexes normally range between 0 to a larger number, depending on local practice, denoting the degree of concentration in a given market. When the values of the indexes approach zero, they indicate that a relevant market consists of a large number of firms of relatively equal size, whilst greater values indicating higher degree of concentration in the relevant market.

In the Provisional Measures, market concentration is defined broadly as a description of market structure reflecting both the number of operators in the market and their market shares. The regulation refers to HHI and CRn as the methods to calculate the level of market concentration, but does not expound a scale for measuring the result of the calculation. Rather as an indicator of whether a merger raises any competitive concern, market concentration appears to be seen as one of the factors directly determining any anticompetitive effect under the Provisional Measures, though it may have to be considered in conjunction with other factors in practice. The Provisional Measures provide that the higher the pre-merger market concentration, the greater is the likelihood of the increase of degree of the post-merger market concentration, and the greater is the likelihood that the participants take anticompetition actions in the relevant market. This seems the position of MOFCOM in the *Pfizer/Wyeth Case* where the agency referred to the post-merger change of HHI in evaluating the competitive effect of the proposed merger. In the case, MOFCOM considered both the post-merger market concentration level and the increase in concentration resulting from the merger, by which it found that the HHI of the relevant market after the merger would be 2,182, an increase of 336 from the pre-merger level. On the basis of this finding, MOFCOM presumed that the relevant market is concentrated without explaining the scale of the index it relied on. Interestingly, it then concluded that "for the reason that the concentration level of the swine mycoplasmal pneumonia vaccines is high, the merger would eliminate or restrict competition". Apparently, the high level of post-merger market concentration as reflected by the change of HHI was simply treated as one of the factors directly determining the competitive effect of the merger.

Effect on Market Entrance and Innovation

The Provisional Measures point out that one of the adverse effects of a merger is that it can raise the barrier for other market participants to enter into the relevant market, which would eliminate or restrict competition. Such effect may be realized by the enhanced control on the market and the resources by the merger participants. In assessing a merger, MOFCOM must take into account how difficult it is for a new market participant to enter into the relevant market. The market entrance by a party not participating in the merger likely can deter and counteract the anticompetitive effect arising from a merger. The Provisional Measures explain that the market entrance may be assessed from the aspects of timeliness, likelihood, and sufficiency. However, no details are given to guide MOFCOM' assessment on the difficulty of market entry.

The Provisional Measures also list the main adverse effects that a merger can possibly cause to technology improvement of its participants. By decreasing competition, a merger may reduce the motive and investment of the participants in technology innovation. The merger participants may also, through increasing control on the market, impede the investment, R&D and implementation of new technology that other competitors may conduct.

This factor was expressly considered by MOFCOM in the *Pfizer/Wyeth Case*. In that case, MOFCOM asserted that the merger would make entrance in the swine mycoplasmal pneumonia vaccines market more difficult, given the high cost and the time required for developing the pharmaceutical products. The likelihood is high that the merger firm would take advantage of the advantageous market position to expand market share in China and to restrict other competitor’s development in the relevant market. However, no detail reasoning is given in the decision. Likely, MOFOCM in the *Uralkali/Silvinit Case* considered the existing control of global potassium resources, the time and investment capital needed for constructing new facilities and getting hold of new resources, as well as relevant technical, environmental and geological risks before determining it would be relatively difficult for other competitor to enter into the market. Moreover, in the *GM/Delphi Case,* MOFCOM considered the difficulty increased as a result of the merger in entering into the GM supply system by domestic part suppliers as an adverse effect of the merger.

Market Efficiency

Articles 9 and 10 of the Provisional Measures address both the adverse and beneficial competitive effects a merger can possibly exert on consumer interest and competitors and upstream or downstream operators. On the one hand, a merger can increase the parties’ power of market control and thus enable them to conduct activities detrimental to the interest of consumers such as raising price, decreasing quality or restricting production output, etc. It can also restrict the operation of and weaken the competitive strength of the non-participant competitors and affect its upstream and downstream operators adversely. On the other hand, it is acknowledged that merger can, through enhancing competition in the relevant market, generate efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in production than either firm could have done without the proposed merger.

When considering the competitive effect of a merger, MOFCOM must consider and balance the entire range of competitive effects arising from a merger deal. It may reject a deal that causes or would potentially cause any adverse competitive effect. However, when the beneficial effects of a merger are notably more prominent than its adverse effects, or the merger would benefit the public interest, which must be proved by the merger participants, MOFCOM may approve the merger either unconditionally or conditionally.

Conclusions

The Provisional Measures reflect the experience MOFCOM has gained from its own antitrust practice. Meanwhile, they have adopted many internationally accepted rules applied in global antitrust merger control. However, the regulation is ambiguously worded and considerably lack of details to guide the implementation of the rules prescribed, as MOFCOM is still studying the rules from the Chinese perspective. This appears to be an attempt of MOFCOM to make its own merger guidelines suitable for China, rather than using the internationally accepted rules and standards. Given the unique complexity in the Chinese market, it will be challenging and taking time.

The Provisional Measures together with MOFCOM's related practice indicate that the agency is fast building its capability in handling more sophisticated international transactions. The agency is also resolved to monitor international mergers and to alleviate any the adverse effects on the Chinese market. Despite there is no clear rules guiding the assessment, MOFCOM seems not hindered from involving in antitrust review of global mergers. International companies with sizable operations related to China must treat the Chinese antitrust filing seriously when considering merger. Not only the legal issues such as filing documents and procedures must be carefully prepared, none legal factors such as the Chinese political and economic context must also be fully examined and understood by international companies preparing for the filing in China. As China is still forming its own antitrust rules, companies must also constantly monitor the development of the Chinese law and practice.

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