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China's Draft Anti-Monopoly Guidelines on Platform Economy

Introduction

China's competition regulator, the State Administration for Market Regulation ("SAMR"), issued a consultation draft of the *Anti-Monopoly Guidelines on the Sector of Platform Economies* (the "Draft Guidelines") on November 10, 2020. This marks China's first major step in formulating a comprehensive regime to regulate competition among platform businesses operated on the Internet (the "Platform Economy") and signals SAMR's changed regulatory priorities with a focus on anti-competitive behavior in the Platform Economy.

The Draft Guidelines attempt to address perceived shortcomings in applying traditional antitrust analysis to the Platform Economy. SAMR has drawn upon the experience of regulators and academics in this emerging area and attempted to consolidate the lessons learnt in various jurisdictions. The Draft Guidelines set out in detail the considerations that may be taken into account and the defenses that may be available, providing some guidance to platform businesses on how to achieve compliance.

While the Draft Guidelines are brief in length, only 23 provisions in total, they are wide-ranging in their scope. Rather than an exhaustive review of the Draft Guidelines, this note examines selected provisions. If implemented in the current form, many more mergers and acquisitions may be subject to China's merger control clearance and antitrust investigation and enforcement may become a much more realistic and serious prospect for Internet-based businesses participating in the China market.

1. Merger Control

(a) VIE structures

For the first time, concentrations involving a variable interest enterprise ("VIE") structure are expressly included within the ambit of SAMR's merger control review if the reporting thresholds are met. A VIE structure is common in the Internet sector in China, whereby a foreign investor uses a series of contracts with the Chinese shareholder of record who is effectively holding equity interest in a Chinese company that has required regulatory permits to operate an Internet business as a nominee for the foreign investor in order to circumvent foreign ownership restrictions. While SAMR never explicitly said the filing requirements do not apply to a transaction involving a VIE structure, the Draft Guidelines signal an end to SAMR's long established practice of not accepting merger control applications involving a VIE structure. SAMR had pursued this practice because it did not wish to be seen as endorsing the circumvention of foreign ownership restrictions by granting merger control clearance for transactions involving a VIE structure. This

meant mergers and acquisitions in the Internet sector and by Internet companies held through VIE structure went unchecked from a competition perspective. These included high profile mergers of tech equals and acquisitions of start-ups. The recent *Shanghai Mingcha Zhegang* case (where one of the parties to the concentration had a VIE structure in its group), which was cleared by SAMR, showed signs that SAMR's attitude to VIEs may change, and this is now reflected in the Draft Guidelines.

(b) Turnover Calculation

The Draft Guidelines address the calculation of turnover in the Platform Economy. They lay down the principle that turnover calculation depends on the business model. For example, for an operator of a platform which provides data matching services only in return for commissions, commissions charged by the platform and other platform income should be used to calculate turnover. For an operator who participates as a principal on the platform, the value of transactions involved in the platform and other platform income should be used to calculate turnover. An example of this would presumably be a business which provides the platform and also itself sells goods and services on the platform. Unlike the financial services sector where only 10% of the turnover of the relevant financial institution is taken into account when determining whether the reporting threshold is met, no similar treatment is afforded to the Platform Economy, potentially making it easy for the turnover reporting threshold to be triggered.

(c) Acquisitions of Start-ups

One of the concerns expressed by commentators in merger control on the Internet sector is that the often low level of sales of a start-up which is the subject of an acquisition is not necessarily reflective of its competitive potential. In this connection, the Draft Guidelines empower SAMR to investigate if the reporting threshold is not met but the proposed concentration may have the effect of excluding or restricting competition and one of the following circumstances exists : (1) a party to the concentration is a start-up or an emerging platform; (2) the turnover is low because the business model of the parties to the concentration involves the provision of free services or services charged at low prices; (3) the relevant market is highly concentrated and the number of competitors is small; or (4) there are other circumstances that have or may have the effect of eliminating or restricting competition.

The discretion given to SAMR is broad, and exceeds the reforms introduced in other jurisdictions. For example, Germany and Austria have sought to address this issue by introducing new reporting thresholds for the value of the transaction, whereas the European Competition Commission's "Competition Law 4.0" did not find it necessary to revise the Merger Control Regulation thresholds. This discretion given to SAMR may result in more mergers and acquisitions being reported to SAMR as parties err on the side of caution. Otherwise, transacting parties will face the uncertainty that their mergers and acquisitions could be investigated after closing with the risk of an unwind or other orders if an adverse finding is made.

(d) **Considerations**

The Draft Guidelines lay down the factors that SAMR may take into account when reviewing a merger control application. Whilst they include the usual factors one would expect, they also set out how these factors are to be considered in the context of the Platform Economy, taking into account its unique characteristics. In particular, for a concentration of operators involving two-sided or multi-sided platforms, the Draft Guidelines suggest a consideration of the two-sided or multi-sided business of the platform and an evaluation of the direct and indirect network externalities.

The factors laid down in the Draft Guidelines include:

- Market share. In calculating the market share of an operator, regard should be had to turnover, the proportion of transaction amount, the number of transactions, the number of users, the number of clicks, usage time and other indicators. Assessment should also be made of the dynamic trend of an operator's market share over time. See section 5 below for a discussion on the definition of "market".
- Market control. In assessing whether an operator has control over a market, regard should be had to whether the operator has exclusive rights to critical and scarce resources and the duration of the exclusive rights, the stickiness and diversification of platform users, the ability of the operator to control and process data, the ability of the operator to control the data interface, the level of profitability of the operator, the frequency and speed of technological innovation, the life cycle of commodities and the likelihood of disruptive innovation.
- Market concentration. In evaluating market concentration, regard should be had to the state of development of the relevant platform market, the number of existing competitors and their market shares.
- Impact of concentration on market entry. In assessing the impact of concentration on market entry, regard should be had to the difficulty of operators obtaining necessary resources and facilities such as technology, intellectual property rights, data, channels and users, the scale of capital investment required to enter the relevant market, and the conversion cost of users in terms of expense, data migration, negotiation, learning and search. The feasibility, timeliness and adequacy of market entry should also be considered.
- Impact of concentration on technological progress. Competition among existing market competitors in technology and business models and the impact of concentration on the motivation and ability of operators to innovate should be taken into account.
- Impact of concentration on consumers. The motivation and ability of the operator to increase commodity prices, reduce commodity quality, reduce commodity diversity, impair consumers' right

and scope of choice, treat different consumer groups differently and improperly use consumer data to harm consumers' interests should be taken into account.

(e) **Remedies**

The Draft Guidelines reiterate the possibility of structural and behavioral conditions for granting conditional merger control clearance. Importantly, among possible structural conditions is the divestiture of intangible assets such as data, although it is not clear whether SAMR intends this to refer to data sharing and interoperability. Among the possible behavioral conditions are the opening up of networks and platforms, the licensing of key technologies and the modification of platform rules or algorithms.

2. Monopoly Agreements

(a) **Horizontal and Vertical Agreements**

The Draft Guidelines detail the types of horizontal agreements, vertical agreements, hub and spoke agreements and collusion which may constitute monopoly agreements in the Platform Economy. In particular, the Draft Guidelines highlight most favored nation provisions and exclusive agreements, which are commonplace in the Platform Economy in China, as potentially constituting monopoly agreements. Whether most favored nation provisions will constitute monopoly agreements will require an overall assessment, taking into account factors including business motives, the operators' ability to control the market and the impact of such provisions on market competition, consumer interests and innovation. Whether exclusive agreements will constitute monopoly agreements will require an overall assessment, taking into account factors such as the market power of the operators, the extent of competition in the relevant market and the impact on entry barriers.

(b) **Relevance of "Market"**

Importantly, China has adopted suggestions made by various academics to overcome the difficulty in defining the market in seeking to address certain types of anti-competitive behavior. For example, the Draft Guidelines provide that a market does not need to be clearly defined when SAMR considers the legality of a horizontal agreement such as price fixing or market segmentation among operators or a vertical agreement involving fixed resale prices and minimum resale prices in the Platform Economy. The Draft Guidelines further provide that where there is difficulty in defining the relevant market, if there is sufficient direct evidence that the behavior has been ongoing for a long period of time, the harm is clear and the behavior can only be sustained by an abuse of market power, then the operator can be deemed to have engaged in anti-competitive behavior without the need to define the market.

3. Refusal to Deal, Doctrine of Essential Facilities and Other Abuse of Dominance

(a) Refusal to Deal and Doctrine of Essential Facilities

Whilst essential facilities remains a disputed doctrine in several jurisdictions, including the U.S., China seems to have embraced it. Under Article 14(4) of the Draft Guidelines, if an operator who controls an essential facility and who refuses to transact with counterparties on reasonable terms, that will be taken into account when determining whether an operator has abused its dominance and engaged in a refusal to deal.

Article 14 states that the following should be considered when determining whether a platform constitutes an essential facility: the substitutability of other platforms, whether there is a potential alternative available, the feasibility of developing a competitive platform, the degree of reliance of the transaction counterparty on the platform, and the possible impact of an open platform on the operator of the platform.

Article 14 further states that the following should be considered when determining whether certain data constitutes an essential facility: whether the data are indispensable for participating in market competition, whether there are other access channels for the data, the technical feasibility of opening up the data and the possible impact of open data on the operator in possession of the data.

(b) Abuse of Dominance and Exempting Legitimate Reasons

Whilst the potential application of the doctrine of essential facilities may not be a welcomed development for platform operators, the other provisions on abuse of dominance in Chapter 3 of the Draft Guidelines may provide some relief. Chapter 3 sets out the different types of abuse of dominance, including predatory pricing, refusal to deal, restraint of trade, tie-in, unreasonable trading conditions and discrimination. For each type of abuse, the Draft Guidelines codifies the case law in other jurisdictions and sets out a list of “legitimate reasons” for an operator to engage in the relevant behavior. These “legitimate reasons” operate as a safe harbor. They effectively serve as a roadmap for the operators to evaluate and potentially reformulate their business practices to ensure compliance. Depending on SAMR’s interpretation, some of the legitimate reasons (e.g. necessity of protecting intellectual property rights and data; the potential of dealings with a transaction counterparty to “inappropriately compromise the operators’ interests” – although it is not clear what SAMR intends this to cover) may give meaningful scope within which an operator can navigate. Details of the types of abuse and the corresponding exempting legitimate reasons in the Draft Guidelines are set out in the appendix to this note.

4. Use of Algorithms

Article 6(3) of the Draft Guidelines captures the use of algorithms to achieve collusion as a form of horizontal agreement. Article 7(3) captures the use of algorithms to directly or indirectly restrict pricing as a form of vertical agreement. Article 9 provides that in establishing collusion in the Platform Economy,

where there is difficulty in providing direct evidence, indirect evidence which is “logically consistent” can be used to establish an operator’s knowledge. It remains to be seen whether this opens the door for use of algorithms to establish collusion. Article 13 also provides that the use of big data to profile consumers and discriminate against consumers in terms of pricing or other transaction terms is differential treatment. The conduct will be illegal if the transaction counterparties are of the same bargaining status and such differential treatment is without justified reasons.

5. Definition of “Market”

Whilst the Draft Guidelines continue to use the traditional substitution analysis in defining a market in the Platform Economy, the Draft Guidelines use the unique features of the Platform Economy as input to such analysis. In defining a market for commodities in the Platform Economy, the features to be taken into account include platform functions, business models, user groups, multilateral markets and offline transactions in a demand substitution analysis; and market entry, technical barriers, network effects, cross-disciplinary competition in a supply substitution analysis. The Draft Guidelines further recognize that a market should not necessarily be defined by reference to a platform’s basic services, but should also include the possible network effects of a digital ecosystem when determining whether a platform should be viewed as an independent market or as involving multiple related markets.

In defining a geographic market in the Platform Economy, demand substitution and supply substitution analysis should be used, taking into account the regions where the majority of the users choose products, users’ language preferences and consumption habits, relevant laws and regulations, the degree of competition constraints in different regions and online and offline integration. A geographic market will usually be defined as China or a specific region; but depending on the circumstances, it may also be defined as the global market.

Conclusion

The Draft Guidelines represent a comprehensive guide to how SAMR intends to regulate anti-competitive behavior in the Platform Economy and signal SAMR’s determination to make regulation of anti-competitive behavior in the Platform Economy a priority. If implemented in their current form, the Draft Guidelines may significantly increase the number of mergers and acquisitions in the Platform Economy that are subject to merger control review and increase the likelihood of findings of antitrust violations and enforcement, resulting in increased regulatory risks and costs for participants in the Platform Economy in China. This may have far-reaching effects, not only on the operators in the Platform Economy in China and their transaction counterparties, but also indirectly on private equity and venture capital investors who have been active in investing in this sector.

SAMR invites public comment on the Draft Guidelines before November 30, 2020.

Abuse of Dominance

Considerations	Legitimate Reasons
<i>Predatory Pricing</i>	
<ul style="list-style-type: none"> (1) whether the platform operator squeezes out other platform operators that have a competitive relationship at a price below cost (2) whether there is a price increase to improperly obtain profits after squeezing out other platform operators 	<ul style="list-style-type: none"> (1) To develop other businesses on the platform within a reasonable time period (2) To promote the entry of new commodities into the market within a reasonable time period (3) Other reasons that can establish legitimacy of the behavior
<i>Refusal to Deal</i>	
<ul style="list-style-type: none"> (1) Stop, delay, or interrupt an existing transaction with a counterparty (2) Refusing to start a new transaction with a counterparty (3) Setting restrictions and obstacles in platform rules, algorithms, technology, traffic distribution, etc., making it difficult for a counterparty to conduct transactions (4) An operator who controls an essential facility in the Platform Economy refuses to conduct transactions with a counterparty on reasonable terms 	<ul style="list-style-type: none"> (1) Unable to conduct transactions due to objective reasons such as force majeure (2) Transaction security is affected due to reasons attributable to the transaction counterparty (3) Transactions with a counterparty will inappropriately compromise the interests of the platform operator (4) The transaction counterparty clearly stated its refusal to deal, or did not in fact, abide by fair, reasonable and non-discriminatory platform rules (5) Other reasons that can establish legitimacy of the behavior
<i>Restraint of Trade</i>	
<ul style="list-style-type: none"> (1) Require the transaction counterparty to "choose one out of the two"¹ or other behavior with the same effect between competitive platforms 	<ul style="list-style-type: none"> (1) Necessary to protect the interests of counterparties and consumers (2) Necessary to protect intellectual property rights or data security

¹ A practice adopted in China where a counterparty is required to choose to deal with one but not both of the incumbent platform operators in China.

Considerations	Legitimate Reasons
<p>(2) Restrict the transaction counterparty to conduct exclusive transactions with the Platform Economy operator</p> <p>(3) Restrict the transaction counterparty to only conduct transactions with designated operators</p> <p>(4) Restrict the transaction counterparty not to conduct transactions with designated operators</p>	<p>(3) Necessary to protect the investment of specific resources for the transaction</p> <p>(4) Necessary to maintain a reasonable business model of the platform</p> <p>(5) Other reasons that can prove legitimacy of the behavior</p>
<i>Tie-in and Unreasonable Trading Conditions</i>	
<p>(1) Use standard form agreements, pop-up windows, mandatory operational steps and other methods that are not subject to choice, change or rejection by the transaction counterparty, to bundle different commodities for sale</p> <p>(2) Use punitive measures such as search power reduction, traffic restriction and technical obstacles to compel the counterparty to accept other commodities</p> <p>(3) Impose unreasonable restrictions on transaction conditions and methods, service provision methods, payment methods and after-sale warranty</p> <p>(4) Charge unreasonable fees in addition to the transaction price</p> <p>(5) Mandatory collection of user information or additional transaction conditions unrelated to the subject matter of the transaction</p>	<p>(1) To comply with legitimate industry practices and trading habits</p> <p>(2) Necessary to protect the interests of counterparties and consumers</p> <p>(3) Necessary to enhance the use value or efficiency of commodities</p> <p>(4) Necessary to maintain the normal operation of the platform</p> <p>(5) Other reasons that can establish legitimacy of the behavior</p>
<i>Discriminatory Treatment</i>	
<p>(1) Using big data and algorithms to implement differentiated transaction prices or other transaction conditions according to the</p>	<p>(1) To implement different trading conditions according to the actual needs of the</p>

Considerations	Legitimate Reasons
<p>payment ability, consumption preferences, and usage habits of the transaction counterparty</p> <p>(2) Using big data and algorithms to implement differentiated transaction prices or other transaction conditions for new and existing counterparties</p> <p>(3) Implement differentiated standards, rules, and algorithms</p> <p>(4) Implement differentiated payment terms and transaction methods.</p>	<p>counterparty and in line with legitimate trading habits and industry practices</p> <p>(2) Promotional activities offered within a reasonable time period for first-time transactions of new users</p> <p>(3) Random transactions implemented based on the platform's fair, reasonable, and non-discriminatory rules</p> <p>(4) Other reasons that can establish legitimacy of the behavior</p>

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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