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Re: ***Comments of O'Melveny & Myers LLP on the Commission's Review of the Competition Rules Applicable to Vertical Agreements***

Dear Sirs,

We are pleased to enclose O'Melveny & Myers LLP's submission in response to the Commission's consultation regarding the draft Regulation on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, and draft Commission Notice, Guidelines on Vertical Restraints.

O'Melveny & Myers LLP would be happy to further discuss any points in the attached document which the Commission finds unclear or wishes to see further elaborated.

Yours sincerely,

Christian Riis-Madsen

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DRAFT REGULATION ON THE APPLICATION OF ARTICLE 81(3) OF THE TREATY TO CATEGORIES OF VERTICAL AGREEMENTS AND CONCERTED PRACTICES, AND DRAFT COMMISSION NOTICE, GUIDELINES ON VERTICAL RESTRAINTS

COMMENTS OF O'MELVENY & MYERS LLP

1. INTRODUCTION

1.1 This document contains the comments of O'Melveny & Myers LLP on the Commission's draft Regulation on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, (the "draft VBER") and draft Commission Notice, Guidelines on Vertical Restraints (the "draft Guidelines").

1.2 This document is set out in two parts:

Section 2 - General overview; and

Section 3 - Substantive issues.

1.3 O'Melveny & Myers LLP welcomes the opportunity to comment on the draft VBER and draft Guidelines, and would be happy to discuss any points in this document which the Commission finds unclear or wishes to see further elaborated.

1.4 These comments are based on the extensive experience of O'Melveny & Myers LLP in advising and representing market participants at all stages of the distribution chain, both within the EU and across the globe. The comments are not submitted on behalf of any of O'Melveny & Myers LLP's clients and cannot be attributed to them.

2. GENERAL OVERVIEW

2.1 It is acknowledged that the general policy rationale underpinning the draft VBER and Guidelines remains largely unchanged for good reason. However, we are strongly of the view that the formulation of the draft VBER and Guidelines in itself must be further developed to "tune-in" more realistically with both the actual and foreseeable methodologies that commercial distribution systems utilise on a daily basis in 2009, and will be utilising over the next decade.

2.2 We further note that the current VBER has not been enforced by the Commission during the last five years. Similarly, we have observed the recent developments in relation to the relaxation of the enforcement priorities of Article 82. As a result, we are of the opinion that it would be consistent for the current review to have resulted in an overall *increased* application of the block exemption. However, it appears that the reality of the situation is in fact the opposite: as currently drafted, the draft VBER will have a significantly narrowed ambit in comparison to its predecessor, especially in view of its revised market share thresholds.

2.3 It is also observed that a number of developments reflected in the draft VBER and Guidelines will be beneficial to the overall functioning of the block exemption, and existing grey areas have been clarified to a certain degree. Nonetheless, we are of the opinion that in order to allow market participants to fully rely on and benefit from the block exemption, the text requires further development in light of the demands encountered in a modern distribution system, and the present-day realities of internet sales.

2.4 While we are mindful that it is impossible to set out all the possible scenarios which may occur, it would nevertheless be beneficial for market participants to be able to refer to a more prescriptive set of rules given the overall lack of guidance in certain areas. Not to do so would result in a number of eligible market participants missing out on the benefits of the block exemption, and leave others largely paralysed due to the resulting doubts over proposed activities. It is logical that market participants are not likely to want to take on the risk of imposing a hard-core restriction, at least not without being able to confidently rely on established and accepted efficiencies.

2.5 Last but not least, as the verticals regime is enforced mainly at Member State level it would be further welcomed that the draft VBER should assist in standardising the increasingly divergent enforcement actions of vertical restrictions which occur across Europe, and avoiding any tendencies to micro-manage. Such inconsistencies only add to the significant burdens attached to the already complex task that market participants face in maintaining a consistent and compliant distribution system across 27 different Member States.

3. SUBSTANTIVE ISSUES

Applicable thresholds for application of the draft VBER

3.1 The current VBER allows parties to most distribution agreements (which do not contain hard-core restrictions) to benefit from the safe-harbour where the supplier's market share does not exceed 30% (or the buyer's market share in the case of an exclusive supply arrangement in favour of the buyer). Such an arrangement logically analyses whether the *party exercising the restriction* has market power or not.

3.2 However, under the revised VBER the safe harbour will only be available where each of the supplier's *and* the buyer's market shares do not exceed 30%. In addition for such purposes, the relevant market share of the buyer is not limited to its share of the market for purchasing the contract goods or services. Instead it is defined as the buyer's share of the market "where it (re)sells", i.e. the share of any downstream market(s) in which it resells the contract products, or sells products which are produced with the contract products. It is proposed that a number of issues arise with such an approach.

3.3 First, from a practical perspective, most suppliers will not be in a position to assess the market share of the buyer in the distribution agreement (and vice-versa), and thereby will find it impossible to know whether the draft VBER is applicable during negotiations. While the current VBER allows the supplier to ascertain whether or not the agreement falls within the safe-harbour by relying solely on an analysis of its own market share (except for exclusive supply obligations), the applicability of the proposed thresholds will require a much more detailed review of the other party's market share. Such a requirement also increases the administrative burden and compliance costs for parties undertaking a self-assessment for the draft VBER, while simultaneously reducing legal certainty for parties undertaking self-assessment.

3.4 Secondly, notwithstanding the increased *de minimus* threshold for non-competing undertakings, the proposed amendment to the 30% threshold will render a high number of agreements which currently (and justifiably) fall within the VBER safe harbour as instead requiring individual review under Article 81(3). While these agreements will involve buyers which have significant market shares, this number will be increased by the fact that the relevant market of the buyer is no longer limited to the market for purchasing the goods or services, but instead includes any downstream markets on which it resells the contract products. Consequently, it is arguable that a high proportion of agreements excluded from the draft VBER will involve buyers with negligible buyer power.

3.5 Where the proposed dual market share test is retained, it is therefore proposed that the buyer side of the test should be limited to the share of the buyer on the market for purchasing the contract products. To retain the downstream markets of the buyer within the draft VBER's market share test will include high numbers of vertical distribution arrangements involving the sale of products produced with potentially minimal volumes of the contract products in question. Such arrangements should not be included in the threshold assessment of whether a given agreement should be able to benefit from the VBER.

Agency

3.6 The draft Guidelines have further developed the current assessment of whether an agreement is a genuine agency agreement, which falls outside the scope of Article 81(1). It is noted that the draft Guidelines now specifically address risks related to "other" activities as opposed to being contract or market specific, allowing for greater legal certainty.

3.7 However, we are of the view that in their overall treatment of the concept of agency, the draft Guidelines still remain rather restrictive and formalistic. It is arguable that their current application does not duly take all the demands of the modern-day commercial distribution chain into account.

3.8 For instance, it is widely acknowledged as normal market practice that certain retailers will always insist on negotiating directly with the main supplier for their required contract product. However, it is also logical that the majority of suppliers are realistically only able to directly deal with a limited number of retailers directly, particularly in relation to handling logistics involved in supply and collection of payments. One obvious answer to this problem would be to allow "box-movers" or other collection agents, who would be well-suited to this role, to act on behalf of the supplier in the capacity of an agent. However, since these both the current and draft Guidelines do not recognise these arrangements as constituting genuine agency agreements, due to the box-mover carrying some financial risk, these arrangements are not considered agency arrangements and subject to the general vertical rules.

3.9 It is thereby requested that the Commission addresses this problem by widening the scope of what is considered to constitute agency.

RPM and Hard-Core Restrictions Generally

3.10 The draft Guidelines take a less restrictive approach towards RPM than the current version. Although stringently limited in scope, steps have been taken to set out where suppliers engaging in retail price maintenance may satisfy the Article 81(3) criteria, which is to be welcomed. Further detailed information is also provided on the perceived negative effects of RPM.

3.11 However, it is noted that within the draft Guidelines and VBER, RPM is still generally categorised as a hard-core restriction. From a risk assessment perspective, it must be accepted that few market participants will realistically take the risk of imposing a hard-core restriction despite the potential efficiencies which are outlined in the draft Guidelines. If good arguments do exist which render RPM as likely to lead to efficiencies, market participants would be more likely to be persuaded of its legitimacy where RPM is no longer listed as hard-core.

3.12 Where this would not be possible (as is expected, given the Commission’s very public stance on the issue) it would nevertheless be beneficial for further guidance to be provided on the potential efficiency arguments which would be deemed acceptable. Similarly, further illustrations of acceptable efficiencies occurring through the use of any other hard-core restriction would be welcomed.

E-commerce

3.13 While the draft VBER and Guidelines have not changed the underlying principle that every distributor must be free to use the internet to advertise or to sell products, it is acknowledged that the additional clarifications provided will assist market participants in applying the VBER to online commerce with more legal certainty. However, it is noted that the current drafts still leave room for further improvement both in terms of removing a number of grey areas which still exist, and taking a more realistic view of the way in which online sales and advertising mechanisms work as a result of internet purchasing habits.

3.14 As reflected in the current Guidelines, the drafts illustrate that the internet is generally assumed to be a passive sales mechanism. At present, only targeted emails/sales promotions are viewed as active selling. However the draft Guidelines do not appear to helpfully clarify the issues involved any further, stating at paragraph 53 that “*as a general rule, a website is not considered a form of active selling to certain customers unless it is specifically targeted at these customers. For instance the Commission* *considers online advertisements specifically addressed to certain customers a form of active selling to these customers*". Paragraph 52 further provides *"If a customer visits the web site of a distributor and contacts the distributor and if such contact leads to a sale including delivery, then that is considered passive selling. The language options used on the website or in the communication play normally no role in that respect."*

3.15 However, we would propose that this is problematic for two reasons. First, we are of the view that it is necessary for the Commission to further provide illustrations of different practical examples which would be regarded as either active or passive websites or other online sales mechanisms. As things currently stand, this will result in suppliers ultimately being forced into the position that they are reluctant or simply unable to prevent potentially "active" online sales mechanisms being established and utilised by distributors in general. For example, will it have any impact on the Commission's assessment if (i) the website is registered under a national address; e.g. will a ".se" website still be considered passive selling in Sweden; or (ii) where the purchaser of an "AdWord" on Google does not limit the resulting online search to any specific Member State(s), and is therefore intentionally EU or world-wide in nature (by the deliberate choice of the distributor)?

3.16 Secondly, we are also of the view that the draft Guidelines appear to overlook the concept that modern online sales techniques are often "active" by their very nature. For instance, a truly UK-based distributor is likely only to go to the trouble of setting up a website in French in the case that the distributor is actually *targeting* French customers allocated to another distributor. Logically, the French version of the website will be largely ignored by UK-based internet users. However, France-based internet users will find and enter the site by virtue of the fact that it is now standard practice to use search engines such as Google when browsing online. In French, the site will be automatically highlighted to the France-based internet user as one of interest, which would not have occurred had the site only been accessible in English.

3.17 On this basis it seems that the concept of passive and active online sales mechanisms is much more grey, in comparison to what is currently described in the draft Guidelines as being almost black and white. It is therefore recommended that it would be useful for the Commission to review its treatment of online active and passive sales by taking a more realistic account of the application of the internet in the way modern sales transactions occur. The differences between active and passive selling on the internet is not as clear cut as other more traditional sales methods.

3.18 The draft VBER and draft Guidelines also propose an added layer of regulation, identifying certain hard-core restrictions in the context of online sales, and other measures which are excepted. Nevertheless, potential issues arise with some of the proposals which do not appear to take account of the realities facing market participants.

3.19 For instance, one of the exceptions illustrated provide that the supplier may require quality standards for the use of an internet site to resell goods in the same way that he may require quality standards for a shop. In the context of selective distribution the example is given that the supplier may even require its distributors to have a bricks and mortar shop or showroom before engaging in online distribution.

3.20 It is acknowledged that while such an exception appears justifiable on the face of it, in reality it will lead to the continued abuse of selective distribution systems by suppliers and hinder the transparency of the specified criteria for access. It is well known that suppliers commonly withhold information on access criteria to online distributors in order to prevent them from being in a position to prove they achieve it (or take the necessary measures to do so). It is also well known that while this "requirement" is already found in a number of selective distribution criteria, that the suppliers themselves discriminate between different online applicants.

3.21 This means that while certain favoured online applicants will be allowed access to a selective distribution network by virtue of the fact they have the products on display in, for example, a small shed, other online applicant distributors will not be party to such knowledge. Such online applicant distributors will thereby be refused access to the selective distribution system on highly discriminatory grounds.

3.22 It is therefore proposed that the Commission should address both the issues of the transparency of criteria for selective distribution systems (in both the online and the offline context) and the discrimination in applying that criteria which is currently encountered. This should be illustrated within the draft VBER and Guidelines in general, and also with specific reference to the bricks and mortar exception as outlined above.

3.23 Another example is the new "proportion of sales test" which renders any requirement on a distributor to limit the proportion of overall sales made on over the internet as hard-core. This does not exclude the supplier requiring, without limiting the online sales of the distributor, that the buyer sells at least a certain absolute amount of the products offline to ensure an efficient operation of its bricks and mortar shop. However, it is further detailed that such an "off-line" sales amount can be the same for all buyers, *or* determined individually for each buyer on the basis of objective criteria such as the buyer's size in the network or its geographic location.

3.24 It is noted that where the supplier holds a position of knowledge over the proportions of sales likely to be made by the buyer both on and offline, such an exception in effect would ultimately allow a limitation to be placed on the proportion of overall sales made on the internet. Similarly, this also allows scope for abuse whereby a buyer who is successful online can ultimately be penalised by their seller, who can impose a high offline requirement in order to limit the buyer's online sales.

3.25 In the case that the exception is retained in its current form, it would nevertheless be useful for the applicable criteria to be further clarified, especially with guidance as to when one option should be applied as opposed to another and an illustration of what would be acceptable objective criteria. It is also unclear whether the possibility of requiring larger offline sales from larger distributors would only be open to suppliers operating a selective distribution system.

3.26 Another newly identified hard-core restriction prohibits a supplier from requiring a distributor to pay a higher price for products intended to be resold by the distributor online than for products intended to be resold offline. While an exception to the rule exists, allowing the supplier to offer the buyer a fixed fee to support its offline or online sales efforts, this would still appear to require any resulting price differentials to be justified by underlying cost differentials existing between the two distribution models. It is proposed that such a requirement imposes a potentially significant administrative burden, especially when it applies to all sizes of suppliers alike.

3.27 It also is arguable that the underlying rationale of this particular hard-core restriction is without foundation in itself. A supplier may justifiably pay a fee or award an additional discount to a bricks and mortar retailer for providing various additional services to its customers (which purely online retailers cannot), without necessarily seeking to restrict online sales.

3.28 Finally, although mentioning the possibility of being indispensible for the achievement of substantial consumer benefit, the draft Guidelines offer no useful guidance as to whether a general prohibition on online sales may be permissible pursuant to Article 81(3) of the Treaty.

3.29 Further explanation of acceptable efficiencies in such circumstances would be welcomed as it would assist suppliers in confidently upholding a restriction where justified. Lack of further direction from the Commission as to what would persuasively fulfil such requirements will ultimately result in a chilling effect, since suppliers will be largely unwilling to take the chance of risking a major fine if their arguments are ultimately not accepted.

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