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

September 28 2009

The ***Asociación Nacional de Perfumería y Cosmética*** **("Stanpa") is an industrial association representing almost all Spanish companies in the cosmetics sector**[1]**.**

The Spanish cosmetics market **represents around 12% of the European cosmetics market**, with value sales approaching 8 billion euros (thousand million). Fragrances and cosmetics are distributed through different channels in Spain: i) perfumeries (27.1%), ii) professional saloons (8.8%), iii) pharmacies (10.3%), iv) drugstores and supermarkets (50.3%) and v) direct sales (3.5%)[2].

Selective market (luxury fragrances and cosmetics) represents 2.1 billion euros. The cosmetic industry provides more that 34.000 direct jobs in Spain, 2/3 of them directly connected with the marketing and sales, and around 24.000 employments on retailers specialized on cosmetics[3].

Stanpa has drafted this document, **with the assessment of CUATRECASAS, GONÇALVES PEREIRA**[4], law firm, to summarize the opinion of the Spanish cosmetics and perfumery industry (the "Industry") on the proposal to modify the Commission regulation on applying article 81(3) of the Treaty to categories of vertical agreements and concerted practices ("RVR"), and on the Commission Notice – guidelines on vertical restraints (the "Notice"). The two documents are referred to collectively as the "Vertical Framework."

The Industry mainly focuses its attention on how a modified Vertical Framework would affect selective distribution, stating that it is satisfied with the current Vertical Framework. Coherently with the progress that has been made in the achievement of the Community's Internal Market, the Vertical Framework focuses on concerns about

[1] http://www.stanpa.es/es/mision.asp

[2] Source: Stanpa. http://www.stanpa.es/es/estadisticasinside.asp?T=2

[3] Source: Spanish Ministry of Employment. Data obtained 31.3.2009. Direct employment: CNAE 20.42 manufacturing of cosmetics: 12.344 employees. CNAE 46.45: commercialization of cosmetics: 22.731 Indirect employment: CNAE 47.45 retailing of cosmetics: 23.858 employees.

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vertical restraints in relation to inter-brand competition, leaving concerns about intra-brand competition and the internal market to other regulations that are more adequate for this purpose (for example, unfair competition and free movement).

Coupled with this attitude, the European Institutions tend to adopt a more economic approach to competition policy. From this point of view, vertical restraints are generally pro-competitive; this is even truer in the case of selective distribution.

To complement the legal assessment, **Stanpa has asked LECG consulting to conduct and economic analyses** *to provide objective opinions and advice that help resolve complex disputes and inform decision makers*[5] about the impact of the proposed revision. The report is included as an annex to this position paper.

This said, the Industry expresses its concerns about several aspects of the proposed reform.

1. Selective distribution as an instrument to enhance competition

Given the special characteristics of European integration and the need to achieve a European Internal Market, the European Union has traditionally pursued a competition policy with the double objective of maintaining a fair level of competition in the market and achieving the European Internal Market [6]. In the early years, the Community courts adopted a conservative approach to vertical restraints in their attempts to fulfill this double objective.[7]

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[5] www.lecg.com

[6] White Paper on the completion of the internal market, Brussels, June 14, 1985. Paragraph 19: *"a strong and coherent competition policy must ensure that the partitioning of the internal market is not permitted to occur as a result of protectionist state aids or restrictive practices by firms."*

[7] See European Court of Justice ("ECJ"), on its judgment of July 13, 1966, *Établissements Consten S.à.R.L. and Grundig-Verkaufs-GmbH v Commission of the European Economic Community.* Joined cases 56 and 58/64. Paragraph 340: *"an agreement between producer and distributor which might tend to restore the national divisions in trade between member states might be such as to frustrate the most fundamental objections of the Community. The Treaty, whose preamble and content aim at abolishing the barriers between states, and which in several provisions gives evidence of a stern attitude with regard to their reappearance, could not allow undertakings to reconstruct such barriers. Article 85(1) is designed to pursue this aim, even in the case of agreements between undertakings placed at different levels in the economic process."*

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However, as we have already stated, the objective of a European internal market has been substantially achieved[8]. Therefore, the tendency has been towards a more economic approach to competition policy in recent years. For example, nowadays, the Community courts apply a consumer welfare approach based on real economic effects, rather than focusing on achieving the internal market.[9]

Therefore, the European Commission should mainly focus its concerns about vertical restraints on consumer welfare. Consumer welfare is closely linked to applying article 81.3 of the treaty, and therefore to the RVR. Community courts' case law establishes that under this article, any kind of agreement between companies can be made exempt[10]. This is even truer in the case of selective distribution, whose pro-competitive effects on the market benefit consumers directly.[11]

The very nature of luxury products calls for the use of selective distribution. When consumers buy luxury products, they expect to receive a personalized customer service[12], with staff advising them and allowing them to test products before buying them, rather than simply buying the product itself. The European Court of Justice ("ECJ") recognizes this when it states that *"(…) the quality of luxury goods such as the ones at issue in the main proceedings is not just the result of their material characteristics, but also of the allure and prestigious image which bestows on them an aura of luxury (…). Since luxury goods are high-class goods, the aura of luxury emanating from them is essential in that it enables consumers to distinguish them from similar goods. Therefore, impairment to*

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[8] The European Parliament states that over 90 % of the legislative projects listed in the 1985 White Paper have been adopted. See Fact Sheets on the European Union: Principles and General Completion of the Internal Market.
http://www.europarl.europa.eu/parliament/expert/displayFtu.do?language=en&id=74&ftuId=FTU_3.1.html

[9] One example is the judgment of the Court of First Instance ("CFI") of September 27, 2006, case T-168/01, *GlaxoSmithKline v. European Commission*. In that case, the CFI established that "*the mere fact that an agreement is intended to restrict parallel trade is not sufficient to support the conclusion that there is an infringement of Article 81(1) EC. In effect, the objective assigned to that provision is to prevent undertakings, by restricting competition between themselves or with third parties, from reducing the welfare of the final consumer of the products in question.*"

[10] See CFI judgment of July 15, 1994, case T-17/93, *Matra Hachette SA*.

[11] See LECG report, pages 6-8.

[12] The selective distribution systems allow both suppliers and distributors to invest in equipping shops and training staff. Such investment enables the service providers to offer customers a personalized customer service, advising them and allowing them to test the products; customers expect and appreciate this service. Also, given the constant innovation in this sector, the launch of new products, and the importance of knowing how to use products correctly to maximize their results, it is essential for service providers to offer a personalized customer service. (See LECG report, page 5).

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that aura of luxury is likely to affect the actual quality of those goods. (…) the characteristics and conditions of a selective distribution system can, in themselves, preserve the quality and ensure the proper use of such goods."[13]

Therefore, for selective networks to be considered an adequate form of distribution, the Community courts require such distribution to be essential to the nature of the product. This requirement is also in paragraph 185 of the Notice, and 171 of the proposed new Notice.

Therefore, we can conclude that the existence of the luxury products market depends on selective distribution[14]. The personalized customer service (including advice and the possibility to test products) and the aura of luxury would not exist without this special method of distribution.

This distribution method also encourages the companies present in the market to constantly innovate, because of the important level of inter-brand competition. Given that the selective distribution method used in the luxury products market helps rather than hinders newcomers to enter the market, it helps further enhance this inter-brand competition. Without a selective system, newcomers to the market would have to invest heavily to try to develop a luxury brand image. Thanks to the selective systems, newcomers that are marketed by the authorized distributors can benefit from competitors' product image. Customers will automatically identify any products marketed through this channel as luxury products.

In short, selective distribution for luxury products is beneficial to consumers and competition.

The proposed reform recognizes the adequacy of the current Vertical Framework, and aims to adopt an even more effects-based approach and consider consumer welfare. One good example of this is the proposed new approach to resale price fixation[15].

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[13] ECJ Judgment of April 23, 2009, case C-59/08, Copad SA v. Christian Dior (not reported yet).

[14] In the Spanish market there are more than 170 different luxury brands, more than 115 new fragrances were launched on 2007. Source: Stanpa.

[15] Paragraphs 219 and following of the proposed new Notice recognize that setting resale prices may be pro-competitive in some circumstances: organizing franchise systems, arranging short-term promotions, launching new brands and opening new markets. This is particularly relevant in the luxury cosmetics market, in which constant product innovation — requiring significant investment in product quality and promotion — is a defining feature. The Industry welcomes this approach in line with recent developments in other jurisdictions (Supreme Court Case *Leegin Creative Leather Products v. PSKS*, June 2008).

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However, some of the proposed modifications threaten to destroy the current equilibrium.

2. The proposed modification of article 4 (b)

Under a clause in article 4 (b) of the proposed new RVR, authorized distributors cannot be prevented from selling products to unauthorized distributors outside their territories where the selective distribution network has not been introduced.

In the RVR now in force, the article reads: *"the restriction of the territory into which, or of the customers to whom, the buyer may sell the contract goods or services, except: (…)the restriction of sales to unauthorized distributors by the members of a selective distribution system".*

The European Commission suggest to replace it by: *"the restriction of the territory into which, or of the customers to whom, the buyer may sell the contract goods or services, except: (…) the restriction of sales to unauthorised distributors by the members of a selective distribution system <u>in markets where such a system is operated</u>"(emphasis added).*

Such modification would, firstly, be in clear contradiction with the definition of selective distribution in article 1 (d) of RVR: *"a distribution system where the supplier undertakes to sell the contract goods or services, either directly or indirectly, only to distributors selected on the basis of specified criteria <u>and where these distributors undertake not to sell such goods or services to unauthorized distributors</u>" (emphasis added).*

As explained, Competition Law requires, for selective networks to be considered an adequate form of distribution, that such way of distribution be necessary to the nature of the product. There is a contradiction between admitting such necessity and, at the same time, allowing that the products be distributed outside the selective network in certain territories.

Contrary to the Commission's intention, the Industry considers that this modification jeopardizes both competition and free movement in the European Union.

Therefore, this clause would have a negative effect on the European Internal Market.

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As has already been mentioned, when the Internal Market has been considerably achieved, considerations in the application of competition law become less relevant. Therefore, we will first set out the effects of the proposed modification on competition law, followed by its negative effects on the free movement of goods.

Concerning competition, we have already explained how selective distribution networks help newcomers in the luxury products sector to access the market. However, the proposed modification introduces a new barrier to such access: a newcomer to the market, willing to establish a selective distribution network[16], will not have the option to make a progressive entry, but will need to start selling products simultaneously in all member states. Products sold to unauthorized distributors outside a certain territory could easily regain this protected territory through parallel imports, and be acquired by other unauthorized distributors. This would breach the distribution conditions in the protected territory, dissolving the brand image which, as explained, is the defining element of the luxury market.

This indirect obligation for newcomers to access the whole EU market will considerably raise their initial expenses, constituting an important barrier to their entry into the market.

Newcomers would not only have to face costs difficulties, but the establishment of a selective network simultaneously in all Member States would add an insurmountable complexity. Negotiations with different dealers cannot possibly be closed simultaneously in every country, and therefore a network cannot possibly be established in all territories at the same time.

Different timing would give rise to legal uncertainty on situations where exports to non-authorized dealers take place during negotiations. Once the distribution contracts are concluded in the territories, should importers be allowed to go on marketing the products even if they are non-authorized dealers? Such solution does not seem consistent with the definition of selective distribution, as exposed previously. But if suppliers would then be entailed to prevent non-authorized dealers from selling their products, that would add the obstacle of detecting those dealers, and in any case, as stated before, the brand image would already be damaged.

[16] We have already explained that selective distribution is essential for the products to be considered luxury products. Therefore, to access the luxury products market, a selective distribution network must be established.

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Taking into account both costs and practical inconveniences, the proposed modification would force suppliers to adopt a global expansion strategy, which is not necessarily the most adequate for the concerned products. The existence of an Internal Market does not necessarily involve the absence of differences in the demand, even more so in relation with luxury products, which are not basic goods.

The Industry would like to highlight the importance of companies' freedom to decide on their own expansion model, taking into account the different market situations. The proposed modification, by making a progressive expansion impossible, would impose a particular and unique expansion model, without taking into account the requirements of each different market.

But even more important is the damage that the modification would do to consumers. Their choice will be reduced, since fewer and fewer products would manage to enter the markets. Also, the offer would vary considerably depending on the territory, since in areas where the selective network is not established, consumers would miss an essential part of the products: the personalized customer service they receive (including advice and the possibility to test products).

In view of these offer divergences, the proposed modification would not contribute to enhance free movement of goods, but on the contrary, it would prevent consumers in the countries where the selective networks are not present from acquiring the same products as consumers in the protected territories. Since luxury products are defined precisely by a different way of distribution that gives them a luxury aura perceived by the consumer through a high-level customer service and advise, the products will be different if acquired under different conditions. Even if in the short term the modification may seem to favor consumers' access to the products, it would cause a progressive degeneration of the products themselves in those territories where they are not sold through the selective network. Not only will provision of article 4 (b) not guarantee consumers in other territories to acquire the same products as in protected ones, but it will prevent them from doing so in the future, as the brand image will already be affected. In conclusion, the Industry want the sentence *"in markets where such a system is operated"* to be eliminated from article 4 (b) in the final version of the new RVR.

3. The proposed modification of article 3

This modification would omit all vertical agreements, in which either the supplier or the buyer has a market share exceeding 30% of any of the markets affected by the

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agreement, from the scope of the RVR. In the current version of the RVR, the supplier's market share was the relevant one.[17]

The modification would contradict the very nature of the RVR. Indeed, instead of providing legal certainty and eliminating burdens for authorities, it would complicate the situation for both companies and authorities.

For example, if a supplier and a retailer are active in different markets, particularly in different geographical markets,[18] it is quite likely that one of the parties will exceed the 30% threshold.[19] With more and more agreements falling outside of the scope of the RVR, companies would face more claims and investigations.

Furthermore, under this system, companies would face increased legal uncertainty, being forced to analyze each distributor's market share in a specific area, while agreements are normally concluded at national level (the supply level). This type of analysis is particularly complicated in the case of distribution networks (e.g., selective systems).

Also, contrary to the European Commission's objective, the proposed solution would be more detrimental to suppliers than to big general stores.

Therefore, the Industry asks the European Commission not to adopt the proposed modification of article 3.

4. Online selective distribution

On-line selling is an especially sensitive question for the Industry. If the measures adopted for its regulation are not adequate, this could put at stake luxury products market as it is now understood, and the Industry as a whole. The potential risks derived from a deficient regulation are described in LECG's report enclosed as Annex I to the present document.

From a legal perspective, the proposed new Vertical Framework raises the following concerns:

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[17] Only in case of exclusive supply, as defined by the RVR was the buyer's market share taken into account.

[18] See, for example, Commission Decision of May 4, 2006. Case COMP/M.4096, Carrefour/Hyparlo. Whereas the supply market is of national dimension, the distribution market is local.

[19] Given the local dimension of the distribution market, market shares will probably be higher.

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Paragraph 52 of the proposed Vertical Guidelines affirms that *"the Commission regards (…) the following as hardcore restrictions of passive selling: (…) requiring a distributor to limit the proportion of overall sales made over the Internet"*. This statement is completed by footnote 29: *"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 (in value or volume) of the products off-line to ensure an efficient operation of its brick and mortar shop, nor does it preclude the supplier from making sure that the online activity of the distributor remains consistent with the supplier's distribution model. This absolute amount of required off-line sales 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"*.

Therefore, if the modification were adopted, the European Commission would consider requiring a distributor to limit the global percentage of on-line sales a hardcore restriction.

Firstly, the Industry considers that an addition of hardcore restrictions is contradictory with an effects-based application of competition law. But even if the reference to hardcore restrictions is finally included in the new Guidelines, footnotes 29 and 30[20] should be incorporated in the main text. The provisions in footnotes 29 and 30 are detailed descriptions of suppliers' rights, not exceptions to the rules indicated in the main text, and should be put at the same level as prohibitions for the sake of certainty.

Under the proposed new Notice, the supplier's only option is to require the distributor to sell at least a minimum absolute amount from its brick-and-mortar shop. This considers the supplier's need to be assured that the brick-and-mortar store will survive.[21]

This objective could be equally attained if the suppliers were allowed to require distributors to guarantee that a percentage of their sales would take place from the brick-and-mortar store, even if this involved, indirectly, restraining the percentage of

[20] Footnote 30 specifies that the fact that the list of hardcore restrictions in paragraph 52 includes *"requiring a distributor to pay a higher price for products intended to be resold by the distributor on-line than for products intended to be resold off-line"*, does not exclude *"the supplier offering the buyer a fixed fee to support its off-line or online sales efforts"*.

[21] For an economic analysis of the consequences of unrestricted online sales, see LECG's report, pages 11 to 16.

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online sales.[22] The proposed solution implies a high level of legal uncertainty, because there is no indication of what amount the European Commission will consider reasonable. Thus, the authorities may sanction suppliers or make their agreements null if they fix such percentages, even if they follow the indications of the Notice.

This proposal has two major drawbacks. Firstly, if suppliers calculate the fixed percentage on a case-by-case basis, they would face burdened negotiations with each potential distributor. Secondly, if suppliers do not calculate the percentage on a case-by-case basis, applying the same percentage to all distributors, it would lead to discrimination between the members of the selective networks, because distributors have different turnovers. Therefore, small distributors would suffer the most.

In any case, in its attempt to avoid limitations on online sales, the Commission oversees the fact that unlimited online sales will negatively affect the brand image[23]. As we have already mentioned, the Community courts consider this brand image inherent to the nature of the luxury products[24]. Therefore, the Industry considers that suppliers should be allowed to limit the percentage of online sales to protect the luxury aura of their products.

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[22] Paragraph 52 of the proposed new Notice establishes that the Commission will treat as a hardcore restriction "requiring a distributor to limit the proportion of overall sales made over the Internet." This restriction prevents suppliers from setting a minimum percentage of sales to take place from the brick-and-mortar store.

[23] A luxury image will be compromised if the high percentage of online sales causes consumers to stop linking the products to a certain personalized customer service (including advice and the possibility to test products), placing the products in a different category. The risk is even higher considering that online consumers will probably identify online sales with popular online shops where the products tend to be second-hand or bargains.

[24] See Judgement of the CFI of December, 12, 1996, case T- 88/92, *Groupement d'achat Édouard Leclerc v Commission of the European Communities*, Rec. (1996) II-1961, paragraph 114: "*the Court considers that it is in the interests of consumers seeking to purchase luxury cosmetics that the luxury image of such products is not tarnished, as they would otherwise no longer be regarded as luxury products. The current segmentation of the cosmetics sector between luxury and non-luxury cosmetics reflects the varying needs of consumers and thus is not improper in economic terms. Although the `luxury' nature of luxury cosmetics also derives, inter alia, from their high intrinsic quality, their higher price and manufacturers' advertising campaigns, the fact that they are sold through selective distribution systems which seek to ensure that they are presented in retail outlets in an enhancing manner also contributes to that luxury image and thus to the preservation of one of the main characteristics of the products which consumers seek to purchase. Generalized distribution of the products at issue, as a result of which Givenchy would have no opportunity of ensuring that its products were sold in appropriate conditions, would entail the risk of deterioration in the presentation of the products in retail outlets which could harm the `luxury image' and thus the very character of the products concerned.*"

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Consequently, the Industry considers that footnote 29 should be substituted by the following paragraph: ***"This prohibition does not apply to selective distribution. In this last case, to avoid unfair enrichment and protect its brand image, the supplier may require from each authorized dealer that a significant part of its sales take place in the brick-and-mortar shop, or set a minimum percentage of sales from the brick-and-mortar shop, provided that sales on-line are not rendered impossible".***

The brand image argument can be spotted in paragraphs 54 and 57 of the proposed new Notice[25] however, the Industry suggests expressly mentioning the brand image and the particularity of luxury products in these paragraphs, in the same way as, for example, dangerous substances are mentioned in paragraph 54[26].

Considering that the personalized customer service (including advice and the possibility to test products) is inherent to the very nature of the luxury products, the Industry suggests that any reference to equivalency or comparability of the criteria imposed to on-line and off-line dealers should be erased from the text, and a that a newsentence should be introduced at the end of paragraph 57 stating ***"given that the personalized customer service (including advice and the possibility to test products) is inherent to the very nature of luxury products, suppliers must be allowed to impose all the necessary conditions to reproduce the personalized customer service (including advice and the possibility to test products) during the online purchase."***

Annex I: LeCG report. E Zoido, S. Pereras. "Review of competition rules on supply and distribution agreements**. An economic view on the proposed revision of the regulation of selective distribution**"

[25] Paragraph 54 establishes the possibility to impose minimum quality conditions on online sellers; paragraph 57 specifies that such conditions must have the same objectives as those imposed on brick-and-mortar distributors. For luxury products, the objective of the conditions imposed on selective distributors is to protect the brand image and the perception of luxury.

[26] The Industry considers that this inclusion is justified by the importance that the brand image has for the very existence of the market, and by the ECJ case law already mentioned.