

COMPETITIVE EDGE

First steps to new ground rules: Preliminary findings of the European Commission's E-Commerce Sector Inquiry

Why is this report important?

The preliminary report published on 15 September 2016 by the European Commission is the first output of a comprehensive review of trends in e-commerce that are relevant to the way in which EU and UK competition law applies to online sales restrictions – both for consumer goods and for digital content. The Commission's inquiry forms part of its Digital Single Market strategy, which aims to ensure better access for consumers and businesses to goods and services.

The Commission's report identifies a number of areas where: (i) it is concerned that companies may not be complying with the law as it stands; (ii) it believes the legal framework may be unduly permissive; and (iii) it may take enforcement action on a case-by-case basis, in line with the approach adopted in previous inquiries, such as those in the energy and pharmaceutical sectors. The final report and the resulting enforcement action is likely to shape law and policy in this area – particularly the next version of the Vertical Restraints Block Exemption and associated guidance, which must be replaced before it expires in 2022.

For suppliers and retailers, the report gives more up-to-date guidance on a number of practices than that contained in the current guidance and addresses areas where there has been controversy – for example on the treatment of bans on resale through marketplaces, or the extent to which rebate schemes amount to "dual pricing" for offline and online sales, where the German authorities have taken a more hard line view than others.

The Commission's report also notes that many retailers engage in "unilateral" action to limit sales to consumers in particular countries through the imposition of territorial restrictions and geoblocking. These activities fall outside the scope of the rules on anti-competitive agreements (since the manufacturer is not imposing an obligation to geoblock on the retailer). However, the Commission published a draft Regulation in May 2016 which aims to restrict geoblocking on retailers' websites and, if implemented, could have far-reaching consequences.

The preliminary report is open to public consultation, with a deadline for comment of 18 November 2016.

Goods and e-commerce: the context

The Commission's preliminary report identifies a number of features of e-commerce that have led to suppliers and retailers reconsidering their distribution models:

- ▶ E-commerce results in greater price transparency for consumers than has been the case in offline markets;
- ▶ This makes price competition more intense, which has immediate benefits for consumers, but may mean less focus on competition on factors other than price, such as quality, brand and innovation;
- ▶ There is also greater free-riding across sales channels – for example, where customers use services in bricks and mortar shops to identify products, but then buy online, or compare and search online and then buy in-store; and
- ▶ Alternative distribution models, such as market places and price comparison tools have made access to consumers easier, particularly for smaller retailers who can reach large numbers of consumers with limited investment.

In response, distribution models have evolved:

- ▶ **Manufacturers** seeking greater control of distribution (including pricing and quality) are more likely to **retail themselves** and compete directly with their retailers;
- ▶ **Selective distribution systems** have become more widely used (19% of respondents have introduced new selective distribution systems) and the criteria applied have expanded;
- ▶ More use is made of **commercial restrictions** on pricing, advertising or where products are sold – for example, restrictions on the use of market places; and
- ▶ **Geoblocking** by retailers that restricts cross border sales is commonplace, but is mostly a unilateral decision of the retailer.

Where are the problems?

The preliminary report identifies a number of areas where there may be concerns, including in relation to a number of practices that might previously have been regarded as acceptable.

Selective distribution systems

The Commission found a significant increase in the use of selective distribution arrangements and is clearly doubtful that the use of selective distribution systems and the criteria they contain are always justified by the nature of the goods. It observes that "discount" retailers may be systematically excluded, even if they meet quality criteria and also that criteria are not always transparent. In particular, the Commission:

- ▶ Notes that a requirement for retailers to operate more than one bricks and mortar store which **exclude pure online retailers** and which currently are generally covered by the Vertical Restraints Block Exemption "...may, in some cases, go beyond what is necessary for the purpose of ensuring high quality distribution..." and may therefore be looked at more closely on a case by case basis;
- ▶ Observes that requirements in selective distribution systems (and otherwise) for retailers to make **investments** in their outlets before being admitted to the system, or in order to qualify for a wider range or better pricing, may also need more careful assessment as to whether those investments are specific to the product; and
- ▶ Found **territorial restrictions** in some selective distribution systems operating across multiple Member States – for example, retailers being limited from launching websites that target Member States other than their home Member State.

For manufacturers currently operating selective distribution systems, those that fall within the Vertical Restraints Block Exemption still have the protection of that safe harbour, notwithstanding the Commission's concerns. As the Commission notes, the benefit of the block exemption can be withdrawn, and the extent to which that happens remains to be seen. Powers to withdraw the benefit of the block exemption have been unused to date.

For selective distribution systems that fall outside the safe harbour (for example because either the manufacturer or retailers have market shares exceeding 30%), greater scrutiny can be expected. The working assumption, based on current Vertical Restraints Guidance, that a requirement for members of a selective distribution system to have a bricks and mortar outlet is likely to be acceptable, is now clearly unsafe.

It is also clear that there is more to come, as the Commission signals its intent to investigate possible anti-competitive clauses restricting online sales in selective distribution systems. The Commission may therefore take a more hawkish approach in future when assessing whether certain types of goods are in reality suitable for selective distribution systems.

Territorial restrictions

The Commission found that geo-blocking is prevalent, particularly in the UK. Where geo-blocking is a unilateral decision by a retailer, this falls outside the remit of competition law, unless the distributor or retailer can be regarded as dominant. The Commission recognises that whether to sell cross-border is often a general business decision of the retailer, taking into account the costs and risks of selling into other Member States.

However, where retailers face contractual restrictions on making cross-border sales within the EEA (including those communicated informally or orally) these may breach competition law. The Commission identified a number of ways in which this appears to happen including:

- ▶ direct contractual restrictions that limit retailers' ability to sell to customers outside the Member State in which they are established or to customers in certain Member States
- ▶ restrictions on passive sales
- ▶ restrictions on active selling irrespective of whether other territories are exclusive to other distributors or reserved for the supplier

The Commission is therefore concerned that agreements do not appear to consistently comply with the EU competition rules. Businesses should check and if necessary reconsider their agreements.

Online market places and price comparison tools

The Commission emphasises the importance of online marketplaces, as a route to consumers for smaller retailers that requires less investment. Equally, it recognises the concerns of manufacturers in relation to the use of marketplaces, in terms of protecting brand image and brand positioning, taking account the availability of counterfeit goods on market places and the need to ensure proper retail services for consumers.

Attitudes to bans on sales via online marketplaces have varied, with the French and German authorities adopting a stricter approach, regarding them as amounting to a ban on online sales, whereas the rest of the EU has tended to view them as more likely to be justified, as indicated in the current Vertical Restraints Guidance. The issue is due to be considered by the European Court of Justice, when a reference from the German Courts in the Coty case is heard.

Interestingly, the Commission has signalled a relatively permissive approach to this issue, concluding that such bans do not equate to an outright ban on internet sales and should not be considered a "hardcore" restriction. These are viewed as a restriction on how the reseller can sell rather than where or to whom it may sell. However, this does not mean that all such bans will be acceptable, particularly where arrangements fall outside the Vertical Restraints Block Exemption safe harbour.

The Commission takes a similar approach to price comparison tools. It considers that absolute bans on the use of price comparison tools without reference to quality criteria may unjustifiably limit retailers' ability to promote their own offer, potentially in competition with manufacturers' websites. However, it recognises that when linked with quality criteria that relate to standards for promoting products on the internet, a restriction on use of price comparison websites may be justified.

The use of "most favoured nation clauses" by price comparison tools have also been the focus of a great deal of attention and controversy across Europe, with different approaches being taken. The report confirms the Commission's view that the effect of such clauses needs to be assessed on a case-by-case basis.

Pricing

The Commission flags that most retailers now track the online prices of competitors and many use automated software to do so. As a result, prices are changed frequently. The Commission also found that dynamic pricing i.e. based on looking at the online behaviour of individual retailers, remains rare. Equally, the Commission did not find retailers selling different prices online and offline.

The Commission identifies that manufacturers provide financial incentives and support in the form of rebates, display discounts, exposure fees etc to support the sales activity of both bricks and mortar and online retailers. The Commission has also identified fixed fees to support offline sales activity as a reaction to free-riding. The Commission notes that costs of investment in offline stores are higher than those for online retailers and does not draw any conclusions from the potentially different mix in support to online, hybrid and bricks and mortar retailers. This may suggest a more permissive approach to providing financial support to bricks and mortar retailers than taken by the German competition authorities in the Lego case, where they concluded that different rebate systems for online and offline sales amounted to "dual pricing" in breach of competition law.

A retailer must be free to set their own prices independently but traditionally RRP's have been seen as acceptable provided they do not amount to a fixed or minimum price. However, manufacturers track retail prices and almost a third of respondents said they complied with price indications given by a manufacturer. We expect that the Commission will pay close attention in future to distribution networks where this is prevalent, to ensure RRP's are not used as a form of resale price maintenance, for example through informal pressure to comply.

Restrictions on advertising

The Commission observes that more manufacturers are selling directly online and so are more frequently competing directly with their retailers in an online environment. It points out that restrictions limiting retailers' ability to use or bid on trademarks e.g. for Google Adwords in order to get a preferential listing on search engines may raise concerns under Article 101. The Commission appears to regard these as restrictions directly limiting competition by taking traffic away from the retailer's site in favour of the manufacturer's site. However, the Commission also indicates that restrictions on the ability to use a manufacturer trademark/brand name in the retailer's domain name may be permissible as they help avoid confusion for consumers, who might expect their search to take them to the manufacturer's own website.

This is one area where there may be enforcement action on a case by case basis either by the Commission or national competition authorities. The German competition authorities have already found such restrictions to breach competition law and the CMA has a live investigation into whether (unnamed) energy comparison sites agreed not to compete for Google Adwords searches.

E-commerce and digital content

The availability of digital content online raises different considerations. Digital content generally benefits from intellectual property protection in the form of copyright and striking the right balance between the IP rights (which are national in character) and competition law has been a thorny issue that has long vexed competition authorities and courts. The Commission has most recently addressed these issues in its investigation of cross-border pay-TV services, where it has accepted commitments from Paramount (although as yet, there is no indication that others in the investigation will offer the

same). These have been controversial as they can be regarded as a requirement by a rights holder to renounce legitimate IP rights.

The Commission identified several themes:

- ▶ **Complex licensing structures** providing exclusive territories, technologies and release "windows" giving temporal exclusivity. The Commission concludes that it may therefore be difficult for new entrants to secure licences for digital content
- ▶ The Commission focussed on **geoblocking** which it found to be commonplace
- ▶ Another feature identified is the long **duration of rights contracts** and encouragement of long term relationships through automatic renewal, rights of first negotiation, first refusal or matching rights
- ▶ **Payment structures** vary and include advance payments, minimum guarantees, fixed/flat fees etc which imply substantial upfront costs for new entrants equivalent to those for larger incumbents, potentially placing entrants at a disadvantage. However, such payment structures may also allow rights holders to share risks efficiently

Ultimately, the Commission concludes that the presence of market power in the supply chain is also a key factor and that it will have to assess whether licensing practices may restrict competition and whether enforcement is necessary on a case by case basis.

What happens next?

The preliminary report remains open to consultation and discussion. It represents the start of a debate that will ultimately lead to a new version of the Vertical Restraints Block Exemption and associated guidance, which must be replaced before it expires in 2022 and will in the meantime also set Commission priorities for enforcement action.

However, even at this early stage, it is clear that the Commission is, in some respects, rethinking its views on a number of practices which it previously regarded as benign. It is therefore important to consider the implications of the Commission's latest thinking now, rather than waiting, particularly if your agreements fall outside of the safe harbour provided by the Vertical Restraints Block Exemption and may be at particular risk of complaints or challenge.

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