

**Response to Public Discussion Document
“Promoting Competition – Maintaining our Economic Drive”**

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5 February 2007

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TABLE OF CONTENTS

<u>Contents</u>	<u>Page No.</u>
I. Summary of Response	3
II. Detailed Responses	5
III. Concluding Remarks	23
IV. References	24

I. SUMMARY OF RESPONSE

In response to the Government’s public discussion document on the way forward for competition policy in Hong Kong, we are pleased to submit this paper for consideration. In summary, our response is as follows.

1. We have no hesitation to say that a competition law for Hong Kong is necessary, if not long overdue. Our analysis is based on the economic efficiency that a competition law will promote and the market distortion that it will cure. Contrary to what some may believe, small market economies are more prone to anti-competitive conduct, due to their unique features of high industry concentration, substantial entry barriers, and high level of aggregate concentration.
2. Laissez-faire does not guarantee fair competition. Given their tremendous costs to society, a reasonable amount of evidence of anti-competitive behaviours will justify a law. A competition law will also protect Hong Kong consumers from international cartels originated from other countries, whose damages are estimated to far outweigh the costs of setting up and enforcing a law.
3. An unbiased competition regime should be extended to all sectors of the economy, in light of the deficiency of a sector-specific approach. We see two main drawbacks of the latter approach: misallocation of resources of the economy in the long run due to the different rules set for different sectors; and a credibility problem that arises when the very same agency acts as both the traditional industry regulator and competition policy enforcer. Nor is it fair to target certain industries of the economy.
4. On the scope of the proposed competition law, we recommend a broad approach covering anti-competitive conduct as well as market structure. In terms of market structure, we do not mean anti-monopoly, as monopoly per se is not anti-competitive. It is only the abuse of monopoly (via predatory pricing, tying and bundling etc) that would be scrutinized. We argue that mergers and acquisitions (M&As) need to be regulated, as they can be motivated by market power considerations as well as efficiency gains. Reduced competition as a result of a merger cannot be reversed by regulating the behaviour of the merged firm ex post. We recommend a light-touched merger control regime with the adoption of large safe harbours, on the justifications that the importance of scale economy in Hong Kong sometimes necessitates a certain degree of rationalization.
5. On the enforcement front, we recommend the set-up of a competition authority empowered with investigative function (plus the power to issue civil injunctive orders) and a specialist tribunal with adjudicative function (the Canada model). It combines the benefits of expertise (of the competition authority) and the safeguards from bias (with independent adjudication), and leads to a high degree of transparency.
6. In terms of sanctions, we propose that punitive fines and director disqualifications be imposed on offenders of hardcore cartels (price fixing, market sharing and bid rigging), and monetary fines, civil or administrative, on all other competition infringements. This is to balance the severity of sanctions against the gravity of harm, and to achieve the necessary deterrent effect against blatant behaviour.

7. We strongly recommend that a leniency program be included in the competition law to encourage whistle-blowing. Whistle-blowing is more effective (if not the only possible means) to detect and lead to successful prosecution of hardcore cartels, as demonstrated clearly by the recent experiences in the US and the EU.

8. We recommend “partial exemption” of small and medium sized enterprises (SMEs) from the new law, similar to the US approach. In our view, exemptions of SMEs from regulations of M&As and abuse of dominant position *can* be justified on economic efficiency grounds. However, price-fixing (market sharing and bid rigging as well) benefits the sellers more than it hurts consumers and hence should be prohibited by law.

9. The safety zone provided by the partial exemption scheme would help reduce SME’s compliance costs and protect them from excessive litigation. At the same time, the law would enable SMEs to sue other players, an option not feasible absent the law, thereby making them better off.

10. No adverse presumption in law should be construed against any type of enterprises, small or big, domestic or foreign. A competition law should neither penalize big players if they are efficient, nor protect small players if they are inefficient. The law is to protect the competition process, not competitors. The government is recommended to do more to educate the public about the nature and essence of competition law.

II. DETAILED RESPONSES

Below are our responses to the twenty questions raised in the discussion paper.

Question 1:

Does Hong Kong need a new competition law?

We submit that Hong Kong needs a competition law to safeguard the competitive process and level the playing field.

Competition law promotes innovation and economic growth by removing or at least limiting constraints on open markets and fair competition. It is the means to correct market distortion by setting up the rules of the game. Without a law any blatant act is legal, it is necessary to outlaw anti-competitive conduct so as to improve market discipline in a true market economy. Contrary to what some may believe, there is a greater need for competition law in small economies. Moreover, growing worries about anti-competitive conduct in and outside Hong Kong justify a competition law. Competition law and enforcement regimes will also deter international cartels from actively targeting Hong Kong consumers, and provide a credible signal that Hong Kong is serious about safeguarding the competitive process.

Competition law aims at enhancing economic efficiency

The objective of competition policy is to enhance economic efficiency, thereby increasing both producer and consumer surplus. Competition is a process of economic rivalry among market players to attract customers. It provides incentive for firms to cater to consumer demand, to lower production costs and to pass on the benefits of innovations to customers. In a perfectly competitive market, firms are forced to act in the best interests of consumers and the society's resources are allocated in the most efficient manner. However, market competition is very often imperfect and firms may engage in practices that restrict competition. When competition is distorted, resources are not allocated as efficiently as they would otherwise, leading to a reduction in social welfare.

Competition law, in setting up the rules of the game, is not intervention. Rather it is to safeguard the competitive process through which to reduce social loss and maximize welfare. Setting up a competition law will not negatively affect Hong Kong's image as the freest economy in the world. (The Index of Economic Freedom of the Heritage Foundation, for example, does not penalize countries with competition laws.) To the contrary, it demonstrates that the competitive environment is fair and encourages investments in Hong Kong.

Competition law is not against big players, nor is it to protect SMEs. It prohibits conduct of all companies that exercise market power to lessen competition. Competition law condemns the abuse of market power, not the possession of market power per se. Even in jurisdictions where there is merger control, it is not a measure to penalize big players for their efficiency. To the extent that competition law deters incumbent firms from foreclosing entry by potential rivals, it will strengthen the incentives of the incumbent and rivals to innovate.

Small economies are more prone to anti-competitive conduct

Small economies exhibit the following characteristics (Gal, 2003): (1) high industry concentration, as small market size can only support a small number of competitors; (2) high entry barriers, as a result of limited supply of key input (land in particular for Hong Kong) and high degree of vertical integration which tends to discourage new entry; and (3) high level of aggregate concentration, as the percentage of economic activity accounted for by the largest firms in the economy is often substantially higher in small economies than in large ones.

Such characteristics imply that the firms in small economies enjoy greater market power, as there are not many competitors around. Markets are not readily contestable because of the inherently high entry barriers. Collusion among firms tends to be easier due to low coordination costs among competitors, less threat of entry which would otherwise upset the existing cartels, plus repeated interactions among the same firms that penalize cheating on cartel agreements.

Openness to international trade helps increase the market sizes of certain industries, but non-tradable sectors (such as real estate, supermarket, petrol retailing, financial services, etc) constantly face distorted competition.

Hong Kong is not immune to anti-competitive conduct

In countries with a well-established competition law, one has witnessed persistent violations of competition provisions over decades, despite the severe civil and/or criminal sanctions. Unable to resist the gains that anti-competitive practices would bring, some businessmen elect to act against the law, after taking into consideration the expected penalties they would face if caught. Given the strong financial incentive on the part of players, it would be naïve to believe that anti-competitive practices are not a problem in economies that do not have a competition law. It runs counter to logic that laissez-faire alone would eliminate anti-competitive conduct.

Without a competition law and hence the process of due investigation, it is impossible to gauge the prevalence of anti-competitive conduct in Hong Kong. In fact one faces a Catch-22 situation. On the one hand, one cannot find enough evidence of bad conduct unless a competition law is set up which gives the enforcement agency the power to investigate and collect evidence of suspicious practices.¹ On the other hand, without sufficient amount of evidence it is argued that there should not be a competition law. Sophisticated businessmen will not publicize their restrictive practices such as price-fixing and bid-rigging, even if such conduct is not outlawed, for fear of negative publicity. Weak competitors may not come forward to disclose unfair plays, for fear of retaliations by dominant players. Absent a law, the internal mechanism and incentives are lacking for the market to expose evidence of unfair plays on its own.

The logic in decision theory is useful in addressing whether there is a need for a competition law, given the Catch-22 situation. In deciding whether measures need to be taken to protect

¹ Without legal investigative power, any attempt to detect bad behaviour would turn out to be futile, as demonstrated by recent government investigation into the fuel retailing sector in Hong Kong. A “no-dirty play” conclusion from such investigations would not be credible, to the extent that the case was not thoroughly scrutinized because the investigation team does not possess legal power for investigation.

its citizens from a potential natural disaster (e.g., an earthquake or SARS), a society would not and should not wait until it is 100 per cent certain that such a disaster will happen. Actions and preventive measures are justified as long as the probability of the occurrence is high enough. Strong evidence would lead to immediate action, but its absence does not necessarily imply that no action should be taken. In the case of competition law, as long as the community as a whole is reasonably worried about anti-competitive practices, as is the case now in Hong Kong, action will be justified, given the high social costs such practices can entail.² It would not be a sensible public policy to delay action in such circumstances.³

Competition law deters international cartels from actively targeting Hong Kong

A competition law would protect Hong Kong consumers from anti-competitive conduct by companies outside of Hong Kong. Clarke and Evenett (2002) found that the vitamins cartels during the 1990s raised prices more in nations without active cartel enforcement regimes, thereby causing greater harm. Moreover, the overcharges from the vitamins cartels were estimated to be US\$178.48 millions on Hong Kong’s imports alone (with re-exports excluded), during the conspiracy from 1990 to 1999.

Benefits of a competition law more than outweigh the costs

While difficult to measure quantitatively, a competition law would lower the price levels by deterring and removing restrictive business practices, thereby benefiting the consumers and companies in the territories. The savings from preventing price-fixing in vitamins cartels alone (see above), or bid rigging in the construction sector, would more than justify the costs of establishing and enforcing a competition law. It is no excuse that the society should tolerate the costs of anti-competitive practices but not the legitimate costs of enhancing economic efficiency.

The compliance costs to an enterprise should be minimal if it abides by the law. Most of the Hong Kong firms, e.g. the SMEs in Hong Kong which account for over 95% of the enterprises in Hong Kong, do not possess market power in the sense of anti-competition, and M&As among them would fall within the safe harbours of a well-crafted regime. If the concept of anti-competitive conduct and competition law becomes better understood, some firms may realize their fears about being inadvertently caught by the law to be unfounded. In addition, increased competition should help bring down the costs of doing business.

The question is how to streamline the framework of competition policy, to make it cost-effective and easily accessible by business players and ordinary citizens. The administrative and compliance costs incurred in a competition regime will pay dividends in the long run, when economic efficiency is realized and market distortions cured.

² The social costs of price cartels, e.g. can be huge. According to the Department of Justice of the US, the vitamin global cartel raised the prices three folds (see Carlton 2003). Studies on the interest rate cartel that existed in Hong Kong’s banking industry during the 1980s - 1990s estimated that the monopoly rents earned by Hong Kong’s banks were about HK\$5.17 billion for 1991, representing about 0.8% of the GDP (see Consumer Council 1994). For the period of 1987-1994, the estimated rents were 1.05% of the respective GDP (Chan and Khoo, 1998).

³ The issue of competition law, of course, is different from the case of protecting society from a natural disaster. For one thing, “bad guys” would be worse off once a competition law is introduced, and the net gain to society would be readily apparent.

Question 2:

Should any new competition law extend to all sectors of the economy, or should it only target a limited number of sectors, leaving the remaining sectors purely to administrative oversight?

We see no legitimate reasons why only certain sectors are targeted. In fact, sector specific competition policy runs counter to the spirit of fair competition.

It is not denied that the current sector-specific approach in Hong Kong seems to be working smoothly. For instance, the regulator in the telecommunications sector considers its regulatory approach (including its competition policy) to be light-handed and market-driven. According to the Office of the Telecommunications Authority (OFTA), regulatory action is taken only when there are market failures, and which are dealt with by applying the minimum necessary remedies. As the regulatory and competitive environments evolve over time, OFTA has in the past two years initiated a series of deregulation measures, including terminating the asymmetric regulation on the incumbent in the local fixed network market since January 2005.⁴

While unique, the current sectoral approach adopted by the Government has aroused various criticisms since its inception. Many critics regard the sectoral approach as piece-meal and inconsistent across sectors (Cheng and Wu 1998 and 2000, Consumer Council 1996 and 1999, Chen and Lin 2002b). A sectoral regulator has no jurisdiction to act outside his designated area (Williams, 2005).

Chen and Lin (2002a) pointed out two drawbacks of a sectoral approach. First, it tends to lead to distortion of resource allocation across sectors of the economy in the long run because of the different rules set for different sectors. Secondly, there is a credibility problem when the very same agency is responsible for two inter-related duties⁵. Performing the dual roles and in possession of asymmetric information, it is difficult for the agency to convince outsiders⁶ that its decisions concerning one duty are made independently of the other duty.

Recently, questions have been raised about the suitability of the sectoral approach. For example, some telecommunications operators complain of the sector being over-regulated; and some are amenable to the idea of introducing a general competition law in Hong Kong rather than being singled out as subjects for competition regulation.⁷ Some auto-fuel companies also prefer a general competition law to sector-specific competition rules in the fuel supply sector, should the government subject them to competition law regulation (Hong

⁴ Since the liberalization of the local fixed network market, OFTA has applied ex ante approval requirement on the tariff of the incumbent operator who was presumed to be dominant in the relevant market. As the market becomes more effective over time, such ex ante approval requirement was considered to be no longer necessary and could dampen the competition that the ex ante regulation was intended to promote. See "Update on the Telecommunications Industry in Hong Kong", presentation by Mr M H Au on 28 June 2006.

⁵ An effective enforcement of competition rules requires fair and independent decisions regarding competition complaints and litigations. But acting fairly and independently does not necessarily mean being able to convince the concerned parties and the public that one has done so. The ruling of a competition case affects not only the parties concerned in the case, but also impacts on future behaviour of other firms. It is therefore extremely important for the enforcer to ensure that not only justice is done, but also "justice is seen to be done".

⁶ See Chen and Lin (2002a) for some anecdotal evidence of this informational problem in communicating with the public about the agency's impartiality.

⁷ According to Dr. K.C. Chan, Chairman of Hong Kong Consumer Council, a policy that targets only a few sectors is no policy (Hong Kong Competition Policy Forum, 21 November 2006).

Kong General Chamber of Commerce, 2005). The logical progression should be to extend the competition regime to all sectors of the economy. While it may be argued that a general competition law cannot take care of different sector specifics, there is no reason why industrial experts with relevant sectoral knowledge (technical or otherwise) cannot be brought in during case analysis and law enforcement when necessary.

Question 3:

Should the scope of any new competition law cover only specific types of anti-competitive conduct, or should it also include the regulation of market structures, including monopolies and mergers and acquisitions?

We argue that the scope of the new competition law should be broad, covering anti-competitive conduct as well as market structures. Given that market structure determines behaviour (the Harvard School Structure-Conduct-Performance paradigm), safeguards against anti-competitive conduct will be more effective when coupled with regulation of market structures.

Monopoly per se does not violate a competition law

As mentioned earlier, competition law condemns the abuse of market power, not the possession of market power per se. It follows that a monopoly position by itself does not violate a competition law (or any law at all). In fact, a monopoly position may be achieved through economic efficiency that surpasses competition. A competition law should never penalize efficiency or protect inefficiency. It is only the abuse of monopoly (via predatory pricing, tying and bundling etc) that would be scrutinized.

We do not propose or suggest breaking up existing monopolies (be they electricity companies, gas companies, essential facilities such as tunnels and seaports etc) for the purpose of dismantling monopoly power. We would emphasize that a competition law is not anti-monopoly. Regulation of market structures should not be confused with specifically targeting existing monopolies.

Scale economy does not preclude “merger to increase market power” motive

M&As are generally driven by such motivations as the desire to realize economies of scale or scope, to reduce competition, or empire building.⁸ Merger control is subject to full market analysis, in order to allow socially beneficial mergers but to prevent socially detrimental ones. It is essential to balance the efficiency enhancing effects of a merger against its potential negative effects on competition. As mergers reduce the number of competitors, it may increase the likelihood of collusive behaviour among competitors, or even affect the extent of entry barriers.⁹ In theory as well as in practice, M&As could be employed as a means to reduce competition or to monopolize an industry.¹⁰ Most, if not all, economies in the world that have competition laws regulate M&As because of the above considerations.

⁸ Possible motives for vertical mergers include reduction of transaction costs, assurance of supply of inputs, elimination of negative externalities among distributors, and increase in market share or power, etc (See Carleton and Perloff, 2005).

⁹ See Williamson (1968-69) for an analysis of the social costs and social benefits of mergers.

¹⁰ Stigler (1950) called the first merger wave in the US near the turn of the 20th century the merger to monopoly movement.

Scale economy is an important determinant of market structure in small economies such as Hong Kong. M&As are prone to occur and more likely to be driven by efficiency considerations. The equilibrium industry structure is thereby more concentrated than that in large economies. But this does not imply that the “merge to increase market power” motive is absent that renders merger control unnecessary in small economies.

In fact, mergers when consummated will reduce the number of competitors in an already very concentrated market. Without merger control, the government would not be in a position to effectively prevent structural changes that can potentially be detrimental to competition and consumer interests. Take the supermarket industry in Hong Kong as an example for illustration. A merger between the two near-duopolists would likely result in a monopoly, given the difficulties new entrants would face (as demonstrated by the failures of Carrefour and Ad Mart in the late 1990s). Social welfare could be greatly reduced should such a merger occur. Given that it is extremely costly, both technically and economically, to reverse a large merger transaction, the damages caused by such a merger would be long lasting even if the government subsequently extended its current competition policy to cover structural issues and take ex post action against mergers. The potential danger of such detrimental structural changes should be taken into account. Prevention is better than cure.

Conduct regulation is no substitute for merger control

Some hold the view that as long as there are effective safeguards against anti-competitive conduct, it might well be superfluous to control merger, since a corporation enjoying market dominance and engaging in anti-competitive conduct would in any event be caught under the law. In our view, conduct regulation is no substitute for merger control, because lost competition as a result of a merger cannot be restored by regulating the behaviour of the combined firm ex post. For example, a merger to monopoly can be blocked in a merger review, if it would substantially raise prices. However, post such a merger, competition is absent no matter how the government regulates the firm’s conduct. A single firm’s setting high prices is normally not regarded as abuse of dominance. Moreover, competition between the merging firms being eliminated, it may inhibit innovation of new products or processes that would otherwise be made had these two firms been competing. Yet no competition law can compel the combined firm (or any firm) to invest more on research and development (R&D) for lack of innovation.

In sum, proper framework to regulate mergers should be introduced. Otherwise it would leave a lacuna in law that could be exploited by companies seeking monopoly rent. The question is not whether mergers should be regulated, but how to design the framework to tailor to the situation of Hong Kong.

Economy-wide coverage of Hong Kong’s merger control is recommended

Regulation of mergers requires caution, given their complexities. A sensible approach is to take into account the specific features of small economies in the design and implementation of policies. The trade-offs between efficiency and market power considerations should be properly considered when defining the screening device or safe harbours, and when evaluating the net effects of a given transaction. Given the importance of scale economies, we argue that competition policy in small economies should be more lenient towards mergers, on the presumption that anti-competitive mergers should be fewer than those in large economies.

Under Hong Kong’s current competition policy, Section 7P of the Telecommunications Ordinance regulates certain M&As involving telecommunications carrier licensees. The framework of merger control does not require ex ante notification to the Telecommunications Authority (TA) on intended mergers. Yet merger proponents may request the formal or informal consent of the TA before proceeding their deal. Such flexibility offered to the industry may reflect the broad view that most mergers in the telecommunications sector are not problematic.¹¹ The TA will initiate an investigation only if a completed merger is likely to raise competition concerns. The burden is on the TA to establish the effect of substantially lessening competition and the absence of outweighing public benefit¹², on the balance of probabilities. In other words, no adverse presumption is construed against the merging parties.

The safe harbours adopted in the telecommunications sector, based on the concentration ratio CR4¹³ and the Herfindahl-Hirschman Index (HHI) tests, are fairly generous to the industry.¹⁴ The screening device and voluntary ex ante notification¹⁵, though not intended to replace case-by-case analysis¹⁶, provides sufficient guidance and promotes certainty to merging proponents. The thresholds adopted by OFTA are quite lenient when compared with those adopted in other countries.¹⁷ Moreover, the control mechanism is very relaxed with the onus of proof placed on the regulator.

We recommend that a similarly light-touched regime¹⁸ be adopted economy-wide, on the justifications that the importance of scale economy in Hong Kong necessitates some degree of rationalization in certain sectors from time to time, and that a merger control regime for Hong Kong should keep compliance costs down, and not cause hindrance or delay to normal business transactions. Due considerations should be given to contestability of the relevant markets and the role of potential competition in evaluating a merger. We further propose that public benefits should be interpreted broadly and generously, on the presumption that most M&As have net offsetting efficiencies.¹⁹

¹¹ In contrast, the Consumers Association of Singapore (CASE) recently questioned the presumption of the Competition Commission of Singapore (CCS) that most mergers in Singapore do not pose competition problem. (See CCS’s website.) Moreover, CASE views that it could be risky to make declarations voluntary, as substantial damage could have been done by the time CCS detects and challenges a problematic merger.

¹² The term “public benefit” is not defined in the Ordinance. The TA is in principle able to consider any benefit at his discretion.

¹³ CR4 is the percentage of market share owned by the 4 largest firms in the relevant market.

¹⁴ Two safe harbours (instead of one) expand the effective coverage of the safe harbour mechanism. Investigation is deemed unnecessary if the merger falls within either of the thresholds.

¹⁵ The voluntary nature of the ex ante notification is distinct from ex ante control, which is a notification and authorisation regime.

¹⁶ The case-by-case analysis is in fact ex post control, a legal exception regime.

¹⁷ In Singapore, the thresholds intended by CCS are based only on the CR3 test (with no reference to HHI), after a public consultation. In Jersey, another small economy that has established a competition law, thresholds on shares of supply or purchase are applied as jurisdictional tests.

¹⁸ While ex ante notification is not required, the competition authority retains the power to investigate specific mergers on its own initiative or in response to third party complaints.

¹⁹ In Hong Kong’s banking sector for example, where merger activities are active, the M&As would pass muster should public benefits be interpreted generously. Special treatment can also be given to industries of strategic importance or fundamental interest (e.g. utility and financial services), based on “national security” considerations or public interest grounds.

Question 4:

Should a new competition law define in detail the specific types of anti-competitive conduct to be covered, or should it simply set out a general prohibition against anti-competitive conduct with examples of such conduct?

We submit that a broad prohibition against anti-competitive conduct along with illustrative examples is appropriate for Hong Kong. Competition laws in the most advanced economies are phrased in deliberately general terms. They get their precise meaning when interpreted upon by competition authorities and courts. When the provisions are disputed in court, the debates are rooted in a concrete context as to how the rules of the game play out in the actual controversies of real life. Broadly drafted prohibition will enable flexibility in its application, able to adjust and adapt to the particular aspects of individual industries.

Uncertainty tends to arise with interpretation of statutes, however precisely drafted. Such uncertainty can be resolved with reference to the reasonings behind leading cases in other jurisdictions, as recognized in the Consultation Paper.

Question 5:

Should a new competition law aim to address only the seven types of conduct identified by the CPRC, or should additional types of conduct also be included, and should the legislation be supported by the issue of guidelines by the regulatory authority?

Addressing the seven types of conduct identified by the Competition Policy Review Committee (2006) will provide sufficiently robust regulation. The meanings of “restrictive agreements” for example can expand to cover new types of anti-competitive conduct as they emerge. Moreover, the instrument of legislative amendments is readily available when the need arises. Finally, the legislation should be supplemented by guidelines to provide clarification and improve understanding.

Question 6:

In determining whether a particular type of anti-competitive conduct constitutes an infringement of the competition law, should the “purpose” or “effect” of the conduct in question be taken into account? Or should such conduct on its own be regarded as sufficient in determining that an infringement has taken place?

The law should clearly outlaw price-fixing, including bid rigging, under the per se illegal rule. No evidence of purpose or effect is required to prove a violation, as justified by established economic theory that under no circumstances can price-fixing in the product market be beneficial to society.

Unlike price fixing, information sharing (about market demand, technological changes etc.) among small firms or trade association members should not be outlawed per se as it generally promotes efficiency. Here the rule of reason sets in. The law should make it explicit that other practices (vertical restraints, mergers and abuse of dominance etc) are treated under the rule of reason, taken into account the purpose or effect²⁰ of the conduct in question.

²⁰ Note the disjunctive “or”. Either “purpose” or “effect” will bite, once established.

Question 7:

Should any new competition law allow for exclusions or exemptions from the application of some or all aspects of the law, and if so, in what circumstances should such exemptions apply?

Automatic exclusions will dilute the effectiveness of the law. There is no compelling reason why blanket exceptions should apply to certain sectors. The better position is for proposed exemptions to be tested under economic analysis, and if considered fit, be exempted from particular aspects of the law only.

Sectoral exemptions should be kept to a minimum

Sectoral exemptions, if justifiable, should be kept to a minimum and subject to periodic review. In line with international practices, labour unions, R&D cooperation (or research joint ventures) and trade associations could be exempted. However, members of a cooperative R&D agreement should be prohibited from collectively marketing their new products, in the absence of justifiable public benefits. Likewise, using trade association as a cover to introduce price-fixing must be prohibited.

Partial exemption of SMEs

To support the growth of SMEs, competition laws in some countries provide special protection to SMEs. In Singapore, some presumptions are construed to exempt certain market participants from Section 34 prohibition (involving agreements or concerted practices) of the Competition Act 2004. Specifically, agreements between SMEs²¹ or other participants below certain market share thresholds²² are generally presumed to have no appreciable adverse effect on competition, hence not caught by Section 34 prohibition.

In the United States, collaboration between competitors²³ will normally not be challenged if the market shares of the collaboration and its participants collectively account for no more than 20% of each relevant market. However, such a safety zone does not apply to price-fixing. Similar to the US practice, we recommend SMEs be exempted from certain prohibition based on efficiency considerations.

Given that SMEs²⁴ do not normally possess market power, not to mention market dominance, we recommend exemption of SMEs from competition provisions governing M&As and abuse of market power.²⁵ However, no firms should be exempted from prohibition of hardcore

²¹ SMEs in Singapore are defined as – manufacturing SMEs if they have Fixed Assets Investments of less than S\$15 million, and services SMEs if they have less than 200 workers.

²² For participants not within the definition of SMEs, exemption is subject to market share thresholds – competing parties with total relevant market share not exceeding 20%, or non-competing parties each not exceeding 25% relevant market share.

²³ Section 4.2 of the Antitrust Guidelines for Collaborations Among Competitors, issued jointly by the FTC and the DOJ, April 2000.

²⁴ SMEs are usually defined in terms of assets or number of employees, which are not good measures for the purpose of competition law. The better criterion is market share, but which is difficult to establish. According to the Trade and Industry Department in Hong Kong, SMEs are defined as follows: manufacturing firms employing fewer than 100 persons in Hong Kong; or non-manufacturing firms employing fewer than 50 persons in Hong Kong.

²⁵ A possible drawback of the exemption scheme is that market structure may be distorted in certain circumstances, for example, when some big companies set up a subsidiary (within the protection of safe

cartels (price-fixing, market sharing and bid rigging). While SMEs in certain sectors may have adopted price-fixing as a means to avoid cut-throat price competition, such practice is harmful to consumers.²⁶ It is well established in economics that the harm to consumers exceeds the gain to the sellers, so price-fixing generates net social losses and should therefore be prohibited per se whether the firms involved are small or big.

Question 8:

Which would be the most suitable of the three principal options set out in Chapter 4 for a regulatory framework for the enforcement of any new competition law for Hong Kong?

The simple structure (Option One) where the investigative and adjudicative powers are combined does not seem to lead to unfairness in Hong Kong's sectoral competition regime²⁷. Given that the specialist regulator is armed with relevant expertise to follow through the cases, such streamlined structure has the benefits of efficiency and cost-effectiveness.

However, there is a lack of transparency without separation of investigative and adjudicative powers. The scope for checks and balances is also much reduced. Wils (2004) has argued that there are theoretical risks of prosecutorial bias. First, confirmation bias – human reasoning tends to search for evidence which confirms rather than challenges one's initial beliefs. Second, hindsight bias – the officials in a second phase investigation may subconsciously avoid information likely to create cognitive dissonance that contradicts a prohibition decision. Third, bias arising from over-zealous enforcement activity – the officials may psychologically equate their achievements with the record of numerous infringements and high fines. While the risks of prosecutorial bias can be contained by professional ethics, vigorous internal checks and balances and judicial review, the controlling mechanisms will however reduce the administrative cost savings.

On balance, we are more inclined to opt for Option Three – adjudication by a Specialist Tribunal. It combines the benefits of expertise (as in Option One) and the safeguards from bias (as in Option Two), and also leads to a high degree of transparency. Though the set-up of a Specialist Tribunal takes time and is costly, it pays dividends in the long run when compared to Option Two of placing excessive demand on the courts (which are not dedicated to competition law).

Question 9:

Regardless of the option you may prefer, should the regulator be self-standing or should a two-tier structure be adopted, whereby a full-time executive is put under the supervision of a management board made up of individuals appointed from different sectors of the community?

We are inclined to opt for a self-standing regulator whose expertise and impartiality can be relied upon.

harbours) simply to carry out certain practices which would otherwise be caught under the anti-competitive provisions.

²⁶ Certain anti-competitive practices may have been perceived as legal ways of doing business simply by convention.

²⁷ The power to investigate and adjudicate is resided in the Telecommunications Authority (TA) and the Broadcasting Authority (BA) respectively for the telecommunications and broadcasting sectors.

A two-tier structure does not necessarily provide better supervision, as issues are more prone to be politicized with an extra layer of hierarchy. It can be counter-productive if board members lack expertise in competition law and economics.

Question 10:

In order to help minimise trivial, frivolous or malicious complaints, should any new competition law provide that only the regulatory authority has the power to conduct formal investigations into possible anti-competitive conduct?

We are of the view that only the competition authority alone should have the power to conduct formal investigations into possible anti-competitive conduct. The competition authority, as a specialist body, should have a vigorous framework in place to conduct preliminary investigation to decide whether prima facie evidence is established before proceeding to a formal investigation. Such framework is adopted in the sectoral approach for the telecommunications and broadcasting sectors. It will filter out trivial, frivolous or malicious complaints.

Individuals with genuine complaints should always lodge their case with the competition authority and furnish it with relevant information to conduct a preliminary investigation. Anonymous complaints are not to be entertained.

Question 11:

What formal powers of investigation should a regulatory authority have under any new competition law?

In order to carry out its duties effectively, the competition authority must have investigative powers with right of access to relevant information. A formal investigative procedure should encompass not only the supply of information by companies, but also the right to enter business premises, to examine business records and to take copies, and to interview representatives or staff members. Limited powers to compel the provision of data or information will jeopardize its investigation.

The exercise of a formal investigative procedure is not necessary in every instance, if market participants are responsive towards a simple request for information. In fact, a cooperative attitude is very much encouraged. When a formal investigative procedure is considered necessary and indeed exercised, market participants’ failure to comply should attract sanctions. Provided that the authority’s right of access is subject to relevance test and confidentiality undertaking, commercial confidentiality and sensitivity should be no bar to disclosure of information.

Question 12:

Should failure to co-operate with formal investigations by the regulatory authority be made a criminal offence?

Uncooperative attitude towards formal investigations exercised by a competition authority is a serious matter, but we are unconvinced that such should be criminalized. The level of penalty to be imposed is an issue of proportionality and deterrence. It is of course too lenient to adopt a “comply or explain” approach towards uncooperative behaviour. It gives the false impression that cooperation is not obligatory in the course of a formal investigation by the authority.

On balance, we are more inclined to opt for the imposition of fines, which can be escalating at a progressive rate, against uncooperative behaviour.

Question 13:

How might a competition regulatory authority deal with the disclosure of information that comes to its knowledge having regard to the need to protect various categories of confidential information on the one hand, and the need to make appropriate disclosure in order to take forward an investigation when the circumstances so require?

Competition authority should be entrusted with the discretion to observe sensitivity of information. The default position is non-disclosure of confidential information. Officials involved in competition investigations are under a duty not to disclose information acquired during an investigation. Information acquired should not be used for a purpose other than the one for which it has been acquired.

The authority should have strict procedures in place to safeguard the sensitivity of information, and to dispose of or archive under classified categories the confidential information when the investigation is complete. The authority is aware of, if not more than the industry participants or the general public, the adverse consequences of a breach of confidence. If in the unlikely event that the authority inadvertently discloses sensitive information, the mechanism to sue for breach of confidence is always available to the provider of information.

Question 14:

Should the existing sector specific regulators that also have a competition role continue to play such a role if a cross-sector competition regulatory authority were to be established?

The roles would evolve as the market scenario changes. When the cross-sector regulatory authority is in place, the competition role of the sector-specific regulator should be phased out gradually, but retained during a transitional period.

A long-term goal of liberalization in the network industries is to replace regulatory oversight and control with the disciplining forces of competition. Liberalization can be viewed as a process by which competitive forces are fostered and strengthened to the point where they alone can impose market discipline on the incumbent's activities. Asymmetric regulation (aiding new entrants and handicapping the incumbent) is only a transitional measure to liberalize the market from monopoly, allowing time for the new entrants to invest in their own infrastructure. The vision behind OFTA's deregulation measures in the past two years is that asymmetric regulation can hinder the development of vigorous competition in the long run.

The philosophy adopted by the economy-wide competition authority is to remove barriers to entry and empower consumers to discipline the market, thereby fostering long-term competition. However, the competition authority at early inception may have only limited expertise and meagre physical and financial resources to oversee also the network industries. To allow time for the competition authority to gain experience and bridge the gap, the sectoral regulator should continue the competition role for a while (perhaps without a pre-

determined timeframe). Eventually, the roles played by the sectoral regulator and the competition authority are to separate and complement each other²⁸.

Question 15:

Should breaches of any new competition law be considered civil or criminal infringements? What levels of penalty would be suitable?

We would propose that punitive fines and director disqualifications be imposed on hardcore cartels, including bid rigging, whereas monetary fines be imposed on all other competition infringements.

Sanctioning policy – deterrent effect, corrective and proportional justice

The aim of a sanctioning policy is focused on its deterrent effect from an economic perspective. Yet non-economic goals should not be ignored, in particular corrective and proportional justice.

Criminal fines are certainly more effective in terms of deterrence.²⁹ From the perspective of corrective justice (compensatory), one may consider it “just” to disgorge the profits gained by the infringement. In the notion of proportional justice, one should also observe the “penalty fits the offence” principle. Policymakers must make choices depending on a balance of the policy objectives.

In Hong Kong’s culture, the society may not readily accept that violations of competition law warrant criminal sanctions (especially when the notions of competition law are still relatively new in Hong Kong). Notwithstanding the experience of the US and Europe, it has not yet been tested locally whether heavy financial penalties will be sufficiently deterrent. Imprisonment of corporate executives for anti-competitive behaviours (essentially economic transactions) may appear very harsh, likely to be rigorously resisted in Hong Kong.

To balance the severity of sanctions against the gravity of harm, we would propose that fines and director disqualifications be imposed on offenders of hardcore cartels (price fixing, market sharing and bid rigging), and monetary fines, civil or administrative, on all other competition infringements.³⁰ This however does not rule out the possibility of reviewing the policy option in future to institute criminal sanctions if warranted by circumstances.

²⁸ In the case of the US when assessing a merger in the telecommunications sector, the Federal Communications Commission (FCC) focuses on public interest test while the Department of Justice (DOJ) and Federal Trade Commission (FTC) on competition effect.

²⁹ The effective leniency program of the US is attributable to the availability of criminal sanctions. In the UK, the Enterprise Act 2002 introduced a criminal hardcore cartel offence punishable with imprisonment and director disqualification and/or fines on individuals, to supplement its national law regime of administrative fines on companies for breach of anti-competitive provisions. In Ireland and Estonia, price fixing and related hardcore cartel behaviour have been criminalized. In Germany and Austria, imprisonment is specifically provided for bid-rigging, plus non-criminal fines on individuals and derivatively on companies (Germany) or only on companies (Austria).

³⁰ Mark Williams also proposed to impose punitive fines on the company coupled with director disqualifications (The Second Asian Competition Law & Policy Conference, December 2006). He argued that sanctions must be “personal” for the law to bite. Imposing financial penalties on the companies alone does not guarantee that the chief executives who have violated the law get penalized, especially when these executives are controlling shareholders, as is the scenario of many conglomerates in Hong Kong. Additionally, financial penalties can easily be passed on in reduced dividends and higher prices.

Level of fines must be predictable, and based on quantitative criteria

Sanctions must have sufficient deterrent effect. It is well reasoned in Bergh and Camesasca (2006) that crimes will be committed³¹ if the expected gains exceed the expected costs, which equal the penalties discounted by the probability of detection and punishment. The economics of law has established that the level of fines must exceed the actual amount of illegal gains to be deterrent, since the probability of detecting a violation is less than one.

Fines can be calculated either on the basis of turnover or by referring to the gains of the offenders or the losses caused by the infringement of the competition rules. Fines based on turnover are relatively easy to assess and will simplify the task of law enforcement, though it is not established that turnover has a direct bearing on the payoff by which the players are tempted to run the risk of punishment. The harm of anti-competitive infringements³² is most difficult to measure. By comparison, the calculation of illegal gains is a bit simpler, but must still be subject to vigorous economic analysis. Camilli (2006) argued that the deterrent effect was specifically linked to the gain from infringement, to the affected commerce and the mark-up.

Different jurisdictions adopt divergent fining policies. These policies seem to be convergent towards quantitative criteria and predictability. In the US, the formula for criminal fine is based on twice the gain to the cartel, or twice the loss suffered by the victims. Fines can be imposed on corporations as well as individuals, and individuals can also face imprisonment. In addition, civil (often “treble”) damages are also well established. By comparison, administrative fines are imposed by the European Commission with quantitative measure to fix the maximum and qualitative criteria to classify infringements in different categories (very serious, serious and minor).

In September 2006, the European Commission has refined its fining policy, and adopted the new 2006 Guidelines³³, which exhibit some novelties. First, the basic fine (up to 30 per cent of the sales value to which the infringement “directly or indirectly relates” in cartel cases) multiplied by the number of years of participation in the infringement. Second, the “entry fee” equal to 15 to 25 per cent of the relevant sales value, untied from the duration of the infringement and is specific to hardcore cartels. One of the Commission’s goals in revising the Guidelines is to increase the predictability of fines.

As for Hong Kong, we propose that hardcore cartels should carry the penalties of heavy fines coupled with director disqualifications, and other lesser infringements carry more discretionary fines. Given that illegal gains may be difficult to measure, fines may be linked to the turnovers of the offenders.

³¹ Taking calculated risks in decision-making is based on the assumption of rational behaviour associated with white-collar crimes, as opposed to a different scenario for irrational crimes (such as murder).

³² It consists of the consumer surplus transferred to the producer, the deadweight loss, the losses in productive and dynamic efficiencies and the costs of rent seeking efforts.

³³ Available at: <http://ec.europa.eu/comm/competition/antitrust/legislation/fines.html>.

Question 16:

Should any new competition law include a leniency program?

We strongly recommend that a new competition law include a leniency program to encourage whistle-blowing. Whistle-blowing is more effective (if not the only possible means) to detect and lead to successful prosecution of hardcore cartels³⁴.

It is widely accepted that a leniency program is an effective means of detecting and destabilizing cartels, as the US and EU experiences have clearly demonstrated. In the US, revamp of its leniency program in 1993 resulted in a drastic increase of cartel detection: 40 international cartels were detected and prosecuted in the US from 1995 to March 2003, and the total industry fines amounted to US\$2,250 millions (Hammond, 2004).³⁵ Similarly, the EU’s leniency program “has proved to be a formidable tool for encouraging firms which have infringed competition rules to cooperate with the Commission. Not only does this allow cartels to be uncovered, but more generally the risk that a member of the cartel might go to the authorities to secure immunity tends to destabilise the activity of the cartel itself and to discourage the formation of cartels in the first place”, per former EC Competition Commissioner Monti (2004).

Leniency program works because it creates genuine fear of detection among cartel members. To quote Hammond’s illustrative example, an empty seat in a scheduled cartel meeting fuels speculation that a missing cartel member has abandoned the cartel, or worse, has blown the whistle. This turns on the race for leniency among cartel members. The fear of detection mentality reinforces the argument that severe sanctions coupled with individual liability will be effective at inducing leniency applications.

Given the anecdotal evidence that cartels are prevalent in many sectors in Hong Kong (construction, petrol retailing etc), a leniency program would help detect existing cartels and prevent future cartels once a law is in place. In addition, a leniency program would help shield Hong Kong from harms of international cartels. Clarke and Evenett (2002) find that overcharges by the vitamins cartels tend to be greater in those economies that do not have a competition law. In fact, a leniency program would increase the overall deterrent effect and lower the potential harm caused by cartels to consumers.

Based on the above findings, we would argue that Hong Kong needs to introduce a leniency program alongside heavy fines and director disqualifications to combat hardcore cartels.

Question 17:

Should any new competition regulator be empowered to issue orders to “cease and desist” from anti-competitive conduct?

A “cease and desist” order will minimize harm to markets soonest possible. We endorse the CPRC’s observation that the process of securing such an order from the courts could lead to delay. We further argue that justice delayed is often justice denied.

³⁴ Cartelisation is difficult to establish because the evidence is circumstantial. The prosecution usually has to make possible inferences from telephone calls, meetings, pricing patterns and other circumstantial evidence. Such inferences seldom meet the standard of proof in a criminal court.

³⁵ Hammond (2004) suggested that uncovered international cartels which operated profitably in Europe, Asia and elsewhere did not expand to the US because of being deterred by the risk of US sanctions under its leniency program.

To expedite an injunction against anti-competitive conduct, we are of the view that the new competition authority should be empowered to issue orders to require parties to cease and desist³⁶ from anti-competitive conduct.

Question 18:

As an alternative to formal proceedings, might any new competition regulator have the authority to reach a binding settlement with parties suspected of anti-competitive conduct?

Binding settlement is a viable possibility. It has the benefits of expediency and spares both parties considerable sum in terms of litigation costs.

We propose that the new competition regulator be empowered with the authority to reach binding settlements with relevant parties as appropriate, provided that transparent procedures and policies are established with proper safeguards to achieve justice.

Question 19:

Should any new competition law allow parties to make civil claims for damages arising from anti-competitive conduct by another party?

As a matter of principle, parties harmed by anti-competitive practices should have the right to compensation. It follows that private action should not be excluded in competition law. But the extent of civil claims would inherently be limited. Also, some safeguards must be put in place to prevent excessive litigation.

First, private parties may lack the financial resources to bring suit or else fear retaliation by the offending parties. Second, private parties may be unaware of the existence and harmful effects of infringement. In fact, overcharges resulting from a cartel are passed on to the ultimate consumers³⁷, each of whom bears a share of the harm, but the causal link is difficult to establish and the level of harm difficult to measure. Third, there is a free riding problem that every victim would be better off leaving the enforcement efforts to others than incurring their own resources to sue. A competition authority is actually in a better position to disgorge profits than private parties. To conclude, the role of private enforcement in achieving justice goals is limited.

While private actions play a role in law, safeguards must be in place to prevent opening the litigation floodgate for market participants to resolve their conflicts of interests under the guise of anti-competitive disputes. To prevent excessive litigation and to contain costs, private actions should only be pursued after the competition authority has made a finding of infringement, and only victims directly harmed should have the jurisdiction to sue.

³⁶ In the US, the FTC is empowered under the Federal Trade Commission Act to issue civil injunctive orders (cease and desist orders) to halt unfair methods of competition, whereas the DOJ has only investigative and prosecutorial functions.

³⁷ There may be several tiers in the distribution chain between the manufacturer and the ultimate consumers. Particular buyers may not be harmed because the overcharge is simply passed on. Some retailers may suffer decreased sales, but such harm is indirect and difficult to quantify.

Question 20:

How should any new competition law address the concerns that our business, especially our SMEs, may face an onerous legal burden as a result of such civil claims?

As discussed above, the extent of civil claims would be limited, and safeguards be put in place to prevent excessive litigation. To allay SMEs’ fears, the long-term measure is to promote education about the role of a competition law, along with some measures to contain compliance costs.

Hong Kong SMEs’ concerns – a contrast to their counterparts elsewhere

SMEs’ concerns are understandable, broadly in terms of three reasons. First, SMEs are used to operate in a free business environment for decades and do not trust or welcome new governmental regulation. Second, it is believed that any new law would inevitably raise the costs of doing business by creating compliance costs. Third, SMEs are reluctant to confront big players in court, even if victimized, for fear of prohibitive litigation costs and/or retaliation.

The above may explain why Hong Kong SMEs respond to competition laws differently from those in other countries. A 2005 survey of UK enterprises by the Office of Fair Trading³⁸ showed that nearly a quarter of SMEs believe that they have been victims of anti-competitive practices. A 2004 survey by the European Bank for Reconstruction and Development and the World Bank³⁹, on enterprises including SMEs in 28 European transitional economies, revealed that 19.73% of firms consider anti-competitive practices of competitors as major obstacles for their businesses, and 23.45% consider those as moderate obstacles.

SMEs would be better off with a competition law

It would be surprising if most SMEs in Hong Kong would not have been victimized by anti-competitive conduct. One possibility is that they simply have not fully realized it.⁴⁰ The likelihood and costs of anti-competitive practices are underestimated by enterprises in Hong Kong, especially SMEs, because the notions of competition law are relatively new and people do not yet have a good understanding of what constitute anti-competitive practices. The most appropriate remedy is to promote good understanding through education, about the social costs of anti-competitive practices and how to realize the benefits of a competition law.

SMEs’ worries about compliance costs are unnecessary, if not unfounded. It is neither suggested nor anticipated that a competition law be introduced with periodic filing requirements. In fact, periodic filing requirements are not required in jurisdictions with competition laws. While SMEs are likely to be exempted from certain prohibitions under the law, the need for legal advice will be kept to a minimum. Therefore, there should not be high compliance costs if SMEs simply abide by the law.

Moreover, SMEs should not resist a competition law simply because they are reluctant to confront big players in court. Even if litigation costs can be high, SMEs are still better off with a competition law than without, at least they have the option to sue big players (if the

³⁸ Survey report “The Competitive Experience of UK SMEs”, by Professor David J. Storey.

³⁹ Business Environment and Enterprise Performance Survey, 2004.

⁴⁰ It should be noted that the survey results only reveal information about what firms perceive as anti-competitive practices.

case is meritorious). Without a law, they have nowhere to seek justice. If SMEs are in fear of retaliation or any jeopardy to their business relationship with big players, a competition law with an enforcement authority will shield them from direct confrontation with big players. SMEs only need to provide evidence and cooperate with the authority in the investigation process, and the authority will take up the task of checking on big players.

To conclude, a competition law will do justice to SMEs by setting up the rules of the game without imposing onerous legal burden (especially as SMEs are likely to fall within the safe harbours provided by law), and enabling SMEs to sue big players for anti-competitive practices. The above is not feasible absent a law.

III. CONCLUDING REMARKS

We have analyzed the special features of small market economies, and how these features exacerbate the problems of anti-competitive conduct. We conclude that a competition law is necessary in Hong Kong to cure market distortion and promote social welfare.

We maintain that a competition law should not selectively target or protect specific enterprises, be they small or big, domestic or foreign. A competition law is not anti-monopoly. It is to protect the competition process, rather than competitors. We recommend a light-touched approach in the implementation of a competition law. This approach comes with a legal exception regime in merger control, partial exemption of SMEs via safety zones, and the set-up of a self-standing competition authority with investigative function and a specialist tribunal with independent adjudicative function.

In terms of sanctions, we propose heavy fines and director disqualifications on hardcore cartels and monetary fines on all other competition infringements, to balance the severity of sanctions against the gravity of harm.

It must be emphasized that a competition law will not hurt Hong Kong’s reputation as the world’s freest economy. To the contrary, it will signal to the world that Hong Kong is serious in levelling the playing field, thereby enhancing the confidence of overseas investors.

Finally, the government is recommended to foster education among the public about the nature and roles of competition law.

*Acknowledgements: The authors would like to thank Catherine C. Y. Fung for her excellent research assistance and contribution to the response paper. Financial support from the Research Grants Council (RGC Reference No.: LU 3002-PPR-2) is acknowledged.

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