

## **Summary note of the CMA roundtable on vertical restraints 16 January 2015**

### **Introduction**

This note summarises the views which were expressed at the Competition and Markets Authority's (CMA) vertical restraints roundtable. The roundtable was attended by 45 external participants from a range of legal firms, economic consultancies and business representative groups (an attendee list is attached). The roundtable provided a forum for external participants to express their views on a range of questions focusing on why businesses introduce vertical restraints, how businesses choose which restraints to introduce, the legal treatment of vertical restraints and how the CMA might successfully engage with businesses on these issues going forward. The views of the participants differed on a number of points and hence this note is not intended to provide a single consistent perspective on vertical restraints.

This note records and summarises the views of the external participants at the roundtable and does not represent the CMA's views or policies. The CMA's representatives attended the roundtable to listen to the views of the external participants and did not seek to defend or explain the CMA's position in respect to the issues which were discussed.

### **Summary of external participants' views**

#### ***Reasons for introducing vertical restraints***

##### *Brand image/equity*

- Throughout the discussions a desire to control a firm's brand image or brand equity frequently came up as a motivation for firms to introduce vertical restraints.
- Whilst this was mainly discussed as a motivation from a manufacturer's perspective it was also noted that this motivation equally applied to retailers (for example for a premium or high-end retailer).

- In practice brand image/equity was often used in a broad sense to refer to a range of product attributes and services which might accompany a physical product and not just the physical characteristics of the product. For example, it could include the retail services and advice which accompanied the sale of the product, the training and support provided to customers or investments made by a manufacturer in developing this and other products. In many cases retailers needed to be provided with an incentive to provide these services and a vertical restraint was one means of doing so.
- This was also not only a consideration for luxury or high-end products. Many firms had identified a niche and had a desire to control their brand image in order to maintain their position within that niche. Additionally, manufacturers had often invested a lot of money in developing new products and identifying distribution models. This applied regardless of whether the product concerned was a luxury product or not.
- There was some suggestion that non-price factors (such as pre-sales service provision) were more important than price factors and maintaining product scarcity in protecting brand image (although the relative importance was highly case specific). Consequently, non-price vertical restraints (such as selective distribution agreements) might be used in this context. However, at the premium end of the market it was noted that pricing was a key concern for many suppliers and there was a particular concern about the effects of heavy discounting by retailers on brands.
- In terms of product characteristics, it was felt that brand image was particularly likely to be a motivation when there was some customer engagement involved in the distribution of the product. For example, if the product was complex or high tech, if there was regular innovation/change or if there were safety concerns (cosmetics were provided as an example of products which were regularly updated so that advice was valuable).
- Participants considered that online sales created a particular challenge. This was because manufacturers had less control over how their product was distributed and presented, the online sales channel was often more prominent and a single outlet had a wider potential reach. In particular, there were fears amongst some manufacturers that their products would be commoditised. This was leading a push towards greater control through selective distribution and agency models.

### *Free-riding*

- Free-riding concerns were also identified as the other major motivation for introducing vertical restraints (especially, although not exclusively, amongst downstream firms, particularly bricks and mortar retailers).

- This concern applied equally to the online and offline sales channels since in both cases there was the potential for consumers to acquire information about the product from one retailer but to then purchase it at a lower price elsewhere. As a result, retailers needed reassurances that their investments would be protected.
- Participants considered that this was an area where the online sales channel created a particular challenge for bricks and mortar retailers for the following reasons:
  - Many online innovations (such as price comparison websites) made prices more prominent and often focused competition on this attribute rather than the wider attributes of the product.
  - In general, there continued to be certain services which could only be provided to customers in a bricks and mortar store. For example, consumers might not purchase a product, especially if it was new or innovative, without having seen and handled it first. Although some online retailers had found ways around this (eg free returns in fashion and retail, online review systems), there was a limit to what could be done. As a result, online retailers may be unable to provide all of the services that a manufacturer would like and which a bricks and mortar retailer was able to provide. Consequently, this provided an incentive to free-ride (whether conscious or otherwise) on bricks and mortar outlets.
  - Switching and search costs were lower online than offline, making free-riding easier.
- It was noted that the bricks and mortar channel might be able to sustain a price premium over the online sales channel but it was queried whether this premium was sufficient to overcome free-riding issues (and to guarantee sufficient margin for the bricks and mortar retailers to invest in eg pre-sale services). It was also noted that many retailers had both an online and bricks and mortar presence. Thus, the main challenge for a manufacturer was often to manage the relationship between these mixed retailers and 'pure' online retailers.
- Consequently, manufacturers may look to restrict the outlets their products were distributed through and they may face particular difficulties monitoring the actions of online sellers. A specific example was that of manufacturers taking online sales in-house and controlling them directly.
- In terms of product characteristics, free-riding was felt to be particularly important for products where there was greater product differentiation and purchases were infrequent. In these cases it was more likely that a consumer would value advice

in order to ensure that they received the most suitable product. Examples provided included cameras, stereos and golf clubs.

- A particularly prominent online example was the use of restraints by online platforms to prevent free-riding by other platforms or retailers. For example, an online platform might want to ensure that it did not just become an advertising window for retailers.

#### *Market segmentation/product availability*

- Generally both online and bricks and mortar sales channels were viewed as important sales channels.
- For example, in the early stages of a product's lifecycle having a prominent presence in offline channels may be important to allow consumers to see, test and to become familiar with a product. In these early stages manufacturers often viewed it as vital to be able to control their product and to ensure that the product was presented appropriately and positioned correctly relative to the alternatives. However, once a product had become more established the online sales channel may be beneficial for achieving scale.
- Alternatively, firms may want to adapt their brands, products or prices in response to the specific conditions of different markets (eg different countries). Or a specific sales channel may provide access to a particularly valuable group of consumers and so firms may have an incentive to ensure that their product continued to be provided through that sales channel. The example of the digital divide and the desire of firms to be able to reach consumers who were only likely to shop offline was provided. Alternatively, manufacturers may want to encourage different types or levels of investments by retailers in different sales channels.
- Consequently, a vertical restraint may be a means of helping a manufacturer to achieve the above objectives and to control its online sales. For example, a manufacturer may introduce a vertical restraint as a means of ensuring it could access a particularly prominent online sales channel whilst ensuring that it met other objectives, such as maintaining its brand image. Or a retailer may insist that it was provided with exclusive distribution of a product if it was to provide access to that sales channel to a new manufacturer.
- Alternatively manufacturers may attempt to use their pricing to encourage retailers to sell to certain geographic markets or consumer groups (the example of the possible use of dual pricing to support bricks and mortar's retailers was provided). Or manufacturers may engage in 'segmented distribution', providing

products which were only available through specific sales channels (typically only for dealers with bricks and mortar stores).

- It was noted that free-riding was not only a concern for bricks and mortar stores and that 'reverse free-riding' was also now a concern amongst some online sellers. Examples of the latter included online sellers investing in a platforms that enabled customers to easily research and compare products but the customer ultimately chose to buy at a physical store. Alternatively there was some suggestion that online retailers might have some competitive advantage in post-sales services (eg hassle-free returns) and that online vertical restraints may be a means of protecting these investments.

#### *Other comments from participants*

- There may be cases in which either the upstream or downstream firm (or an intermediary such as a platform) pushes for a vertical restraint to be introduced (notably if one party had made a significant material investment and/or if there were significant asymmetries in the supply chain eg a major brand and a small retailer or a major retailer or sales outlet and a new product).
- However, in many cases the incentives of the upstream and downstream firm (and consumers) may be aligned. For example, consumers may be uninformed but want to ensure that they are matched to the most relevant product for their needs. As a result, manufacturers wanted to ensure that their retailers provided pre-sales advice so that the manufacturer's reputation for providing good quality products, and therefore their brand image, was maintained. Similarly, the retailer would like to do the same, but it was unable to do so due to free-riding from other retailers.
- In many cases multiple incentives would interact and in practice a firm would rarely be trying to resolve one particular problem but multiple issues simultaneously.
- The online sales channel created many challenges and uncertainties for firms because it was developing very rapidly and because it was prominent. As a result, many firms perceived that decisions were harder to reverse once they had been made. For example, once a firm decided to allow distribution through online platforms it was harder to go back on that decision and to regain control of how the product was distributed.
- Many of the issues were not fundamentally new. However, online sales channels presented some new challenges, for example regarding the ability to control how a product was distributed and the increased price transparency the internet provided. Such changes helped to explain why online sales were often

particularly targeted by vertical restraints and why online sales attracted particular attention.

- Online retail platforms created particular challenges and care should be taken not to treat all such platforms as low end distribution channels. When considering the incentives of businesses and the effects of various agreements, there should also be a distinction between retailer platforms and those where the platforms were selling software linked to some hardware. For example, in the case of digital content where platforms were also involved, there may be no clear distinction between manufacturer and retailer (ebooks were provided as an example). It was suggested that the incentives of the platform and those using the platform may be less well aligned than in a more traditional retailer-manufacturer relationship.

### ***The choice of vertical restraint and the legal treatment of vertical restraints***

- There was a strong theme that legal considerations were the over-riding factor guiding firms in their choice and structure of any vertical agreement.
- There was also a sense that firms often followed successful firms and adopted similar arrangements to those adopted by the most successful firms. Additionally, firms were often using rather dated arrangements which had often been employed over many years (and had not necessarily been updated to changing circumstances). In reality implementation may be somewhat different and arrangements may be more informal.
- This combination of firms following successful firms and continuing to use long-standing arrangements may imply that businesses may find it difficult to identify and to explain exactly why they entered into such agreements and what the effects of changing these agreements would be. Consequently, any subsequent engagement with firms would require careful facilitation.
- In contrast, it was noted that businesses would often have multiple methods of distribution and types of distribution agreements for a specific product. Therefore, there may not be a single type of vertical restraint which was most appropriate for a product with a certain set of characteristics.
- Many examples were provided of how the current legal framework was felt to affect the agreements which we see in effect. For example, legal prohibitions on resale price maintenance (RPM) meant that manufacturers may not be able to control their retail prices through RPM agreements. However, instead this may push them towards considering highly restrictive selective distribution arrangements, agency models, restrictions on price advertising or various forms of vertical integration (at the expense of the product being more widely

available). Alternatively, manufacturers may publish recommended retail price lists which were subsequently interpreted as minimum retail prices by retailers.

- Participants also expressed a range of views on the current legal treatment of vertical restraints both within the UK and more broadly. The key points were:
  - There was a lot of legal uncertainty which had a chilling effect on businesses (examples provided included the scope and interpretation of agency<sup>1</sup> agreements, specifically whether price comparison websites were seen as agents or not and the willingness of jurisdictions to pursue RPM cases).
  - This uncertainty arose partly from differences across jurisdictions but also from changes in business models and the vertical restraints which could be used and how they would be perceived (for example the apparent treatment of price parity clauses and the restrictions introduced by platforms).
  - Perceived differences in the interpretation and application of the current European Commission guidelines across jurisdictions also created challenges for firms. These differences were a significant consideration for firms that often needed to ensure that their arrangements satisfied all authorities.
  - There was some feeling that online and offline sales channels should be treated equally. For example, if a brand allowed its products to be sold via cheaper bricks and mortar retailers then why should that brand be able to require that retailers do not sell through online platforms? Or if a retailer was already part of an authorised retailer network then why should they not be able to distribute products as they see fit?
  - Some participants also questioned whether the current approach to online sales bans was the correct one (ie should online sales restrictions be perceived as restrictions on passive sales). In particular, why was a website considered to be passive sales but advertising considered active sales?
  - There was some suggestion that more cases, providing clear legal precedents would be helpful. In particular, it was suggested that with new, novel restraints authorities should not seek the least controversial way to solve them (eg commitments) but should seek to reach a decision (even if this was a no grounds for action or a 101(3) decision). In particular, authorities should be careful when stretching the 'object' box. However, there were also warnings that greater legal certainty ran the risk of creating

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<sup>1</sup> Here an agent is meant in the legal sense as defined in paragraph 12 of the European Commission's *Guidelines on Vertical Restraints*.

hard and fast rules which risked becoming quickly outdated and insufficiently flexible.

- There was a tension between the desire of firms to tailor their product offering (and pricing in particular) to different markets across different countries and the focus of the EU on the single market. It was suggested that a firm may choose not to release products in some EU markets where pricing would need to be lower if this created a risk of undermining the firm's position in higher priced markets.
- It was felt that the development of the internet had expanded inter-brand competition and there should be a greater acknowledgement of this when considering vertical agreements which restrict intra-brand competition. For example, it was felt that greater consideration could be given to the parallels between the approaches to vertical agreements and vertical mergers (the latter of which would allow a legalised form of RPM).



## Annex – Attendee list

<i>Organisation</i> <i>(at the time of the roundtable)</i>	Name
Addleshaw Goddard	Rona Bar-Isaac
Baker & McKenzie	Fiona Carlin
Baker & McKenzie	Samantha Mobley
Berwin Leighton Paisner	Adrian Magnus
Bird and Bird	Victoria Moorcroft
British Brands Group	Sarah Keen
Burges Salmon	Laura Claydon
Charles Rivers Associates	Matthew Bennett
Cleary Gottlieb Steen & Hamilton	Paul Gilbert
Clifford Chance LLP	Alastair Mordaunt
Clifford Chance LLP	Alex Nourry
CompassLexecon	Peter Davis
CompassLexecon	Justin Coombs
Cooley	Becket McGrath
Cosmetics, Toiletry and Perfumery Association	Olivia Santoni
Cosmetics, Toiletry and Perfumery Association	Chris Flower
Cosmetics Europe	Isabelle Martin
DLA Piper UK LLP	Kate Vernon
DWF	Brona Heenan
Eversheds LLP	Stephen Rose
Frontier Economics	David Parker
Gibson Dunn	Deirdre Taylor
Gowling WLG	Bernardine Adkins
Herbert Smith Freehills	Kim Dietzel
King & Wood Mallesons	Phil Girardet
KPMG	Claudio Calcagno
KPMG	Maria Maher
Latham Watkins	Omar Shah
Linklaters	Helen Crossley
Linklaters	Nicole Kar
Maclay Murray & Spens	Catriona Munro
Norton Rose Fulbright	Ian Giles
Olswang	Howard Cartlidge
Oxera	Helen Jenkins
Orrick	Matthew Rose
Pinsent Masons	Alan Davis
PwC	Luisa Affuso
RBB Economics	Adrian Majumdar
Shepherd Wedderburn	John Schmidt
Sidley Austin	Stephen Kinsella
Simmons & Simmons	Tony Woodgate
Squire Patton Boggs	Diarmuid Ryan
CMA	Alan Giles
CMA	Philip Marsden
CMA	Mike Walker

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John Kirkpatrick  
Chris Walters  
Simon Constantine  
Ann Pope  
John McInnes  
Borbala Szathmary  
Hugh Mullan  
Richard Burch  
Carlotta Dandolo  
James Rutt  
Gaucho Rasmussen  
Kate Collyer  
Andreas Hoefele