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Huya/Douyu and Tencent/China Music Group - a “new normal” for Chinese merger control?

Adrian Emch (Hogan Lovells, China) · Sunday, August 22nd, 2021

Since December 2020 Chinese antitrust enforcement has become visible to a larger audience. Some in the Chinese antitrust community have even identified a “new area.” A number of speeches by the country’s top leadership over the past few months – including a key speech in December 2020 – have indicated high-level support and may have been the catalyst for increased antitrust enforcement under the Anti-Monopoly Law (AML).

The stepped-up enforcement was clearly visible in the decision against Alibaba, issued by China’s antitrust authority – the State Administration for Market Regulation (SAMR) – in April 2021. There, SAMR imposed a record fine of over RMB 18 billion (around EUR 2.4 billion) on Alibaba for abuse of dominance. In addition, since December 2020, SAMR has issued over 50 decisions punishing companies for failure to file reportable transactions under the AML’s merger control rules.

Last month, there were two additional developments to provide further evidence of a changing landscape in the Chinese merger control arena: on 10 July 2021, SAMR issued its decision prohibiting the merger between Huya and Douyu; on 24 July 2021, SAMR published its decision imposing remedies on Tencent’s acquisition of a controlling stake in China Music Group.

The two cases are two “firsts.” The *Huya/Douyu* decision was the first “adverse” merger control decision adopted by SAMR and its predecessor against a transaction without foreign participation. In turn, *Tencent/China Music Group* is the first case where SAMR and its predecessor imposed remedies post-closing, in a failure-to-file procedure.

Huya/Douyu case

Huya Inc. (Huya) and DouYu International Holdings Limited (Douyu) are both Cayman-registered companies listed on US stock exchanges. Tencent is a shareholder in both companies. According to the decision, it solely controls Huya and joint controls Douyu together with the Douyu founder. Through the transaction, Huya

planned to acquire the entirety of Douyu's shares, and Tencent would thereby (indirectly) acquire sole control over Douyu.

Tencent notified the transaction to SAMR in November 2020. At the expiry of phase 3 of the procedure (i.e., the extended phase 2) in June 2021, Tencent pulled and refiled the transaction afresh. Three weeks later, on 24 July, SAMR published its decision prohibiting the transaction from going ahead.

On the substance, SAMR identified a horizontal overlap in the live broadcast gaming market in China, where the merging parties had a combined market share of over 70% in terms of revenues.

In addition, SAMR found a problematic vertical relationship between Tencent in the upstream Internet gaming operation services market (where Tencent was found to have a market share above 40%) and the merged entity in the downstream live broadcast gaming market. SAMR held that Tencent and the merged entity would likely engage in foreclosure tactics at both levels (input foreclosure and customer foreclosure). Interestingly, the decision contains a single sentence on the key change of the transaction - the change of Tencent's joint control over Douyu to sole control - finding it to further strengthening dominance. The decision only summarily states that pre-transaction, there was a limited degree of competition between Huya and Douyu, which would then disappear post-transaction. The decision does not feature any further discussions on the changed ability or incentive for Tencent to engage in foreclosure strategies (or horizontal strategies).

The decision mentions that Tencent submitted a remedies proposal in April 2021, almost three months before the decision was issued. Without further explanations, the decision concludes that the proposal was not sufficient to remove the competition concerns. As a result, SAMR prohibited the transaction.

Tencent/China Music Group case

Similar to Huya and Douyu, Tencent and China Music Group are Cayman Islands-incorporated companies.

In July 2016, Tencent signed an agreement to acquire 61.64% of shares in China Music Group. The transaction was closed by registration of shareholder changes in December 2017.

In its 24 July 2021 decision, SAMR found that, through the acquisition of the 61.64% stake, Tencent acquired sole control over China Music Group and that both Tencent and China Music Group's revenues were above the filing thresholds. As a result, SAMR found that the acquisition was a reportable transaction, yet Tencent had not filed it under the AML's merger control rules.

What distinguishes *Tencent/China Music Group* from all other decisions where SAMR and its predecessor sanctioned companies for not filing reportable transactions is that SAMR also took issue on the substance. *Tencent/China Music Group* is the first and

(so far) only among the 110 failure-to-file decisions, where SAMR and its predecessor found the transaction to have anti-competitive effects.

In particular, SAMR found the merging parties to have a high combined market share (70% in terms of revenues and higher on other metrics) in the Internet music broadcast platform market. It further pointed to the high numbers on the Herfindahl-Hirschman Index, and the fact that the merging parties are close competitors. SAMR found that the merged entity would be able to raise entry barriers through its large amount of exclusive music rights and by way of making high non-reimbursable royalty payments to music rights holders. It further held that Tencent's rich music right catalogue post-transaction would increase users' switching costs and prevent rivals from reaching a viable scale. SAMR also found that market entry by competitors had significantly decreased after closing (as compared to the period between signing and closing and before).

Based on this analysis, SAMR imposed a fine for failure to file - RMB 500,000, around EUR 65,000, the maximum amount under the AML - and also imposed remedies on Tencent:

- SAMR prohibited Tencent from entering into new exclusive music rights licensing agreements with record labels and other licensors (except for individual artists and for new songs) and ordered Tencent to rescind existing agreements of this kind. For individual artists, exclusivities up to three years are possible, and exclusive "first releases" of new songs are possible for up to 30 days.
- Absent valid reasons, Tencent is not allowed to request conditions from music rights licensors that are more favorable than those granted to other Internet music platforms. Existing agreements to the contrary need to be amended.
- Tencent cannot offer excessive pre-payment to licensors in order to indirectly raise rivals' costs.

Beyond these remedies, SAMR imposed a number of requirements on Tencent which do not seem to exactly match the competition concern identified in the decision. In particular, SAMR imposed some merger filing obligations on Tencent which go beyond the existing legal framework:

- If Tencent has a "concentration" (i.e., an acquisition of a controlling right in another company) that does not meet the filing thresholds but may have anti-competitive effects, it has the obligation to submit a filing to SAMR and suspend closing until SAMR clearance. This obligation differs from the current rule (in an AML implementing provision) which grants SAMR the option to investigate concentrations below the thresholds, but does not impose filing and standstill obligations on the parties.
- For transactions that do not amount to a "concentration," SAMR appears to require Tencent not to participate in any commercial decision-making in the target company (except for protecting its rights as a minority shareholder) and to submit an annual report to SAMR listing all such transactions for a period of three years. This requirement of not participating in decision-making could be interpreted as being more stringent than the current definition of acquisition of a "controlling right" (which is thought to focus on veto rights, rather than mere participation in decision-

making). However, the language in the decision is murky, and might as well be interpreted as a somewhat imprecise of the definition of a “controlling right.”

In addition, as one of the remedies, SAMR required Tencent to improve compliance and participate in building a fair market competition mechanism. These requirements are similar to those SAMR included in its administrative guidance letter to Alibaba in April 2021.

What’s next?

The two decisions signal an important shift in Chinese merger control.

Up until now, there had not been any prohibition decision or conditional clearance decision in purely domestic transactions. The vast majority of such types of decisions involved purely foreign-to-foreign transactions. Now, the *Huya/Douyu* decision shows that SAMR is ready to tackle transactions between purely domestic players.

Similarly, up until now, there have been over 100 cases where SAMR and its predecessor found an unlawful closing of an unreported transaction, but only in *Tencent/China Music Group* did SAMR find anti-competitive effects and imposed remedies post-closing.

Clearly, the *Huya/Douyu* and *Tencent/China Music Group* decisions need to be viewed within the larger context of increased regulatory scrutiny against tech companies (in particular Internet players) that is currently ongoing in China. However, it would be imprudent to view the decisions as purely politics-driven, to dismiss the antitrust substance underlying the two decisions or to blend out the decisions’ impact on Chinese antitrust enforcement more generally.

From a policy perspective, there seems to have been high-level political support for increased antitrust enforcement for quite some time (as reflected in the high-level push for the “fair competition review system,” an initiative to examine governmental rules from the competition angle). It seems therefore unlikely that antitrust enforcement levels would decrease again after the current enforcement focus on Internet players is over.

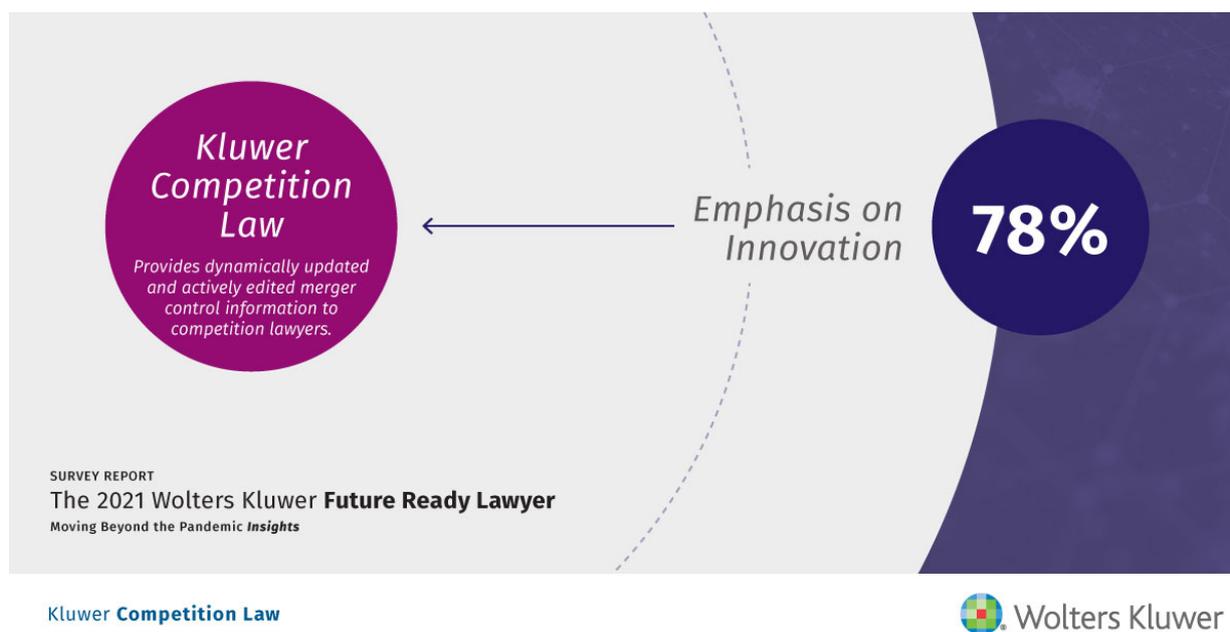
At the moment, there are reports that SAMR’s antitrust team size could grow substantially. If so, it would be prudent to expect companies in other sectors – both foreign and domestic – to come under intense antitrust scrutiny. In that sense, the *Huya/Douyu* and *Tencent/China Music Group* decisions showcase SAMR’s increased confidence in pushing antitrust enforcement into new areas.

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