The Federal Antimonopoly Service

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PRESSING MATTERS OF DEVELOPING COMPETITION IN THE RAILWAY INDUSTRY OF THE RUSSIAN FEDERATION

The railway industry in the Russian Federation has been undergoing significant transformation since the second part of 1990s; structural reforms, integration on the post-Soviet space (the Common Economic Space and the Eurasian Economic Union by 2015).

The paper analyses emerging pre-conditions for competition in Russian railway industry and specifics of the main processes influencing its development, in particular:

- The main stages of reforming railway sector in the post-Soviet Russia, a brief description of its modern structure
- Types and forms of competition in freight and passenger transportation
- Possibilities to use competitive procedures in the railway sector
- Mechanism of charging for access to the infrastructure of the railways in general use and investments in development of railway infrastructure; opportunities for private investments
- Developing the segment of high-speed transportation in Russia.

A BRIEF HISTORY OF REFORMS AND THE STRUCTURE OF RAILWAY SECTOR IN THE POST-SOVIET RUSSIA

In 1996 a National Congress of Railway Workers adopted the “Main Areas for Developing Railway Transport” in Russia that outlined an evolutionary ideology of industry reforms, drawing lessons from some unsuccessful attempts to reform railway companies in other countries.

In 1998 the Government of the Russian Federation approved the concept of a structural reform in the railway sector, which identified the fields of the reform without indicating specific measures, and on 18th May 2001 – the Programme of structural reforms, that opened the way to reforming the railway sector in Russia. The Programme had three stages.

At the first stage “Russian Railways” OJSC was formed, development of competitive sector of railway transportation started, particularly, by establishing freight operators that own rolling stock, creating conditions for non-discriminatory access of railway services users to railway infrastructure, measures to ensure mutual access of federal railway organizations and organizations owning railways to each other’s infrastructure, separating the functions of state regulation and economic management in the railway transport, etc.

The second stage was characterized by establishing subsidiaries of “Russian Railways” OJSC, stage-by-stage reduction of cross-subsidization, a transition to free pricing in competitive sectors, attracting investments for developing railway transport.

At the third stage it was necessary to continue attracting investments for developing railway transport by selling blocks of shares of subsidiaries of “Russian Railways” OJSC and other shareholding railway companies, the shares of which were owned by the state.

In 2011 the Target Model of the freight market was adopted to achieve the objectives of the Structural reform in freight services and developing railway industry for the period up to 2015. Since 2012 common railway space has been forming within the Common Economic Space, typically, without exemptions and restrictions.

Following the reforms of federal railway transport its structure includes:

- “Russian Railways” OJSC – the owner of the infrastructure of railway transport in general use and a common network-wide freight operator on railways in general use. For a certain period there were many licensed operators but in reality only “Russian Railways” exercised freight transportation
- Freight operators that own cars and provide freight cars for consignors (the market of freight operators in Russia is very well developed - over 1700 operators)
- Operators providing long-distance passenger transportation (“Federal Passenger company”

- 29 operators specializing in commuter passenger transportation.

Non-core activities underwent corporatization by establishing subsidiaries in:
- Rolling stock repair, spare parts manufacturing
- General construction
- Agriculture
- Other non-core activities.

Before 2004 non-public railway tracks, owned by industrial railway companies, and switchers were privatized. Since 2004 private freight fleet has increased from 25% to 80%.

The following current initiatives are put forward to change the railway industry structure further:
- Developing competition among independent freight operators “for routes” and “on routes”
- Privatizing non-core activities of “Russian Railways”
- FAS initiative to create commercial market infrastructure
- Establishing international competition between freight operators within the Eurasian Economic Union from 2015.

**COMPETITION IN THE RAILWAY SECTOR IN THE RUSSIAN FEDERATION**

In Russia competition exists within railway transportation and between railway and other types of transport, in both freight and passenger traffic but to a different extent.

**Competition in freight transportation**

**Competition within the railway transport.** By 2003 a system of freight tariffs for freight was established for inventory fleet (cars of “Russian Railways”) and owned / leased cars. The first regulated tariff has three elements: car, infrastructure and locomotive; the second – only locomotive and infrastructure elements.

The market of freight cars was liberalized stage-by-stage. Majority of the cars of “Russian Railways” were transferred to the ownership of two operators: “First Freight Company” OJSC (“PGK” OJSC) and “Second Freight Company” (“VGK” OJSC) (from February 2013 – the “Federal Freight Company” (“FGK” OJSC) and operators specialized in container shipment (“TransContainer” OJSC), refrigerator (“Refservice” OJSC), etc. The remaining cars were sold on competitive basis to private operators. “PGK” OJSC and “VGK” OJSC were formed as subsidiaries of “Russian Railways”; in 2011 “PGK” OJSC was privatized.

As a result of consolidation in 2008—2013 the number of car operators reduced from 2100 to 1700; however, the market remains highly competitive. Since 2003 total investments in the sector have reached 600—700 billion RUB (14—15 billion euro), over 300,000 new freight cars are built.

After 2004 more than 200 companies had freight licenses; in reality, however, only “Russian Railways” was involved in freight. Since 2012 the range of licensing services has reduced significantly and licensing remains only for transportation and loading – unloading dangerous goods. Such licenses are granted to “Russian Railways” and operators of specialized cars for oil and gas, etc.

The Target Model postulates competition between operators “on the market” (route), which, in FAS opinion, is more efficient, and “for the market” (route). Competitive relations are developing, for instance:
- On the route: freight operators acting as carriers – transporting goods (oil, oil products by own trains “Transnoil” Ltd., “Baltrtransservice” CJSC
- For the route: transporting goods from the infrastructure in general use to the infrastructure of industrial companies by a locomotive of the owner of the infrastructure of industrial companies, or a locomotive of “Russian Railways”.

International and Russian experience shows that structural reforms including vertical and horizontal disintegration can considerably increase transactional costs of interactions between new participants of competitive markets. To reduce transactional costs and take full advantage of competition, commercial market infrastructure must be formed.

From 1 January 2015 carriers from Belarus, Russia and Kazakhstan should be able to have mutual access to the infrastructure of these countries under the framework of the Eurasian Economic Union.

With the railway reforms and liberalization of the freight cars market more frequent violations of the antimonopoly law by “Russian Railways” are observed. One of the largest cases in 2011 was abusing market dominance by “Russian Railways” that avoided integrated freight services in the part of providing cars. More than 40 largest consignors complained to FAS. The company was imposed the largest fine in euro). “Russian Railways” appealed FAS decision at Court; judicial proceedings continue.
Competition between different types of transport. Goods transportation by rail remains the major type of freight carriage in the Russian Federation (not accounting for pipelines): around 85% for the past 7 years (Table 1). Road transportation is becoming a notable competitor: within the last three years its share increased from 8% to 10% (Table 1). As a result, some goods markets demonstrate a very intensive competition between railway and road transport. For some routes cost-efficient haul distance can reach 1500 km. At the same time marine and inner waterways transport in the past three years decreased from 7% to 5%, indicating low and gradually decreasing competition between railway and water transport.

The same trends are observed as pipelines are added. Moreover, due to reducing share of pipelines, the share of railways increased, especially in 2010 - 2012 (Table 2).

Competition in passenger transportation

Competition within the railway transport. The Structural reform also required deregulating tariffs in the passenger segment. In 2002 it covered passenger transportation in compartments and luxury cars, and commuter trains of enhanced comfort.

As a result, since 2002 competition has been developing in inter-city as well as commuter sectors and alternative carriers established in some markets: “Tver Express” Ltd. - 2009, “FPK” OJSC - 2010, “TransClassService” CJSC – 2011, etc., in inter-city transportation. In commuter sector: “Aeroexpress OJSC (the share of “Russian Railways” - 50%) - 2005, “Interregional Passenger Company” Ltd. - 2009 (a private company), “Perm Express” Ltd. - 2010 (founded by a subject of the Russian Federation), “Regional Express” Ltd. – 2011, and other carriers. The main competitors of “FPK” OJSC in interstate passenger transportation are “Russian Railways” and private carriers, mostly on the Moscow – St Petersburg route.

29 carriers operate in commuter transportation in 70 regions of Russia. At the same time competition between 6—7 carriers is present on 5—6 routes (over 70% of total commuter railway passenger transportation in Russia). Thus, in commuter sector competition for a route is declared while competition within a route takes place but not widely.

Commuter companies were formed through vertical and horizontal disintegration and corporatization of “Russian Railways”, and attracting regional authorities and (limited) private owners to the company capital. The companies operate the rolling stock leased from “Russian Railways”. Tenders for exclusive services in some regions are being discussed.

Competition exists between commuter carriers and enhanced comfort carriers, as well as between commuter carriers and regional passenger carriers (typically, “FPK” OJSC in inter-regional transportation. Therefore, passengers can choose a type of carriers and transportation.

Similarly to the freight sector, the railway reforms increased the number of antimonopoly violations by passenger carriers. For example, in October 2011 FAS found that “FPK” OJSC violated Article 10 on the Law “On Protection of Competition”. The company

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Note: the share of air transportation is insignificant, well below 1%.
abused market dominance by reducing the number of seats in third class sleepers in long-distance train on Yekaterinburg – Moscow route without any economic or technological reasons in spite of demand for such seats. The company was fined 427140 RUB, which it paid in full, and did not challenge the decision.

In November 2011, FAS found that “Russian Railways” violated Part 1 Article 10 on the Law “On Protection of Competition” (abusing dominance and infringing passenger interests by economically and technologically unjustified decrease of services in spite of demand for them). “Russian Railways” replaced a train operating in Moscow and the Moscow region in the morning “rush hours” and carrying over 1000 people at the government regulated tariffs with a fast, enhanced comfort train carrying 600 people at the price twice higher than the regulated tariff. FAS issued determinations to ensure access of the population to the service of a holder of natural monopoly – railway transportation. The decision and determination were overturned by Court. At the same time during the judicial proceedings, a new train was added to the morning time-table transporting over 1000 individuals at the government regulated tariffs, while the enhanced comfort train also stayed in operation.

### Competition between different types of transport
Railway passenger transportation competes with air, road (cars and buses) and water transport.

In 2000 the former Ministry of Antimonopoly Policy proposed to adopt a flexible tariff system in railway passenger transportation depending on a season and demand. Transportation by first class cars and compartments in luxury trains was deregulated. For providing exclusive services. Tender criteria should include minimizing budgetary expenditures and detailed requirements to the bidders and contracts.

At the same time, universal access to passenger transportation services was guaranteed. Passengers were able to choose between car classes as well as types of transport.

In the second part of 2000s, the system of flexible regulated tariffs and the system of deregulated tariffs continued as it proved to be successful. In 2013, upon an initiative of FAS and “FPK” OJSC, on 10 long-distant routes (from Moscow to St Petersburg, Smolensk, Voronezh, Nizhny Novgorod, etc.) with developed competition with other means of transport a pilot project of “dynamic pricing” was launched when prices change depending on a season, a day of the week, the demand and the number of sold tickets. The project includes over 100 fast and passenger trains; the cost-effective haul distance can reach 1000 km.

Due to a system of dynamic pricing “FPK” OJSC expects that in 2013 the passenger transportation in the deregulated segment will increase by 4—5%. FAS trusts that dynamic pricing must form the benchmark for pricing in the regulated segment.

The share of railway transport in the overall passenger traffic in the past 7 years has been decreasing (Table 3), with the sharpest decrease – by nearly 10% in 2009 - 2012 against a considerable growth of air traffic - by 11%. Road transportation has been decreasing since 2004, although in the recent years some stabilization is observed. Thus, the most competition to railways is from air transport, although road transport remains a serious competitor. The share of water transport is insignificant meaning absence of competition with railways.

### TENDER PROCEDURES IN THE RAILWAY SECTOR IN RUSSIA

#### Tender procedures in the railway passenger transportation in Russia

At the moment no tender procedures for carriers exist. FAS believes that decision-making should be based on market analysis and competition “on” and “for” the market must be maximally developed. Competition “for the market” can be efficient in the field that needs subsidies and when there are several candidates for providing exclusive services. Tender criteria should include minimizing budgetary expenditures and detailed requirements to the bidders and contracts.

Competition “on the market” can be efficient when market analysis identifies the necessary conditions for competition within the railway sector or with other types of transport. If competition is limited, flexible tariff regulation must reflect changes in supply and

<p>| Table 3. Passenger traffic by types of transport, 2004–2012 |
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Regulation of Natural Monopolies

Scientific and Practical Electronic Journal

The legislative framework of passenger railway transportation should establish service standards, including the minimum social transportation standards. The mechanism of public procurement can be engaged.

International experience shows that the best effect is achieved through saving budgetary funds. In FAS opinion, loss-free operations of carriers can be achieved by setting economically justified tariffs or the level of market prices and allocating targeted budgetary support to certain categories of the population.

To optimize budgetary expenses and grant subsidies to those in need, FAS proposes that:

- On the routes without alternative means of transport 50% should be third-class cars with regulated tariffs
- On the routes where a carrier has the dominant position, 30% - 50% should be third-class cars with regulated tariffs
- On the routes with substitute types of transport 30% should be third-class cars, tariffs can be deregulated.

Tender procedures in other railway sectors

In 1999 the Government recommended holders of natural monopolies (HNM) to use tenders for procurement of products (services) for their needs. In 2011, No. 223 Law “On Procurement of Goods, Works, Services by Certain Types of Legal Persons” obligated HNM to organize tenders. All information about tenders must be published at a web-site.

FAS investigated several cases against HNM for violating, in particular, Article 17 of the Law “On Protection of Competition”. For example, in 2009—2010 a branch of “Russian Railways” – the Central Administration for Freight Car Repair organized two open tenders for equipment maintenance. FAS established that in spite of the same tender subject, “Russian Railways” fixed different procedures (indicators and score criteria) for determining the winner. The same person was declared the winner, which means that information was not put across potential bidders. FAS asked Court of Law to invalidate the contract.

In 2012 found that “FPK” OJSC violated Article 17 of the Law “On Protection of Competition” in an open tender for maintenance and repair works of equipment in all types of cars in 2012—2026. Alter placing a notice, the company changed the tender documentation tightening qualification requirements for the bidders such as an extended experience of works similar to the tender subject. FAS concluded that only one company met the requirement because it had been carrying out such works for “FPK” OJSC from 2010. FAS asked Court of Law to invalidate the tender and the contract.

Charging for access to the infrastructure in general use in Russia

Under No. 147-FZ “On Natural Monopolies”, regulated tariffs are designed to support performance and development of regulated economic entities. Tariff decisions are based primarily on the measures of state support for developing infrastructure in general use.

In the freight sector “Russian Railways” as a carrier and the infrastructure owner applies a government-regulated fee that has three elements: car, infrastructure and locomotive. If a consignor uses cars of operators or own cars, the fee includes two elements: infrastructure and locomotive; the car elements is not regulated by the state.

The fee for access to the infrastructure in general use is network-average. Differentiating tariffs for particular infrastructure segments will help eliminate “bottlenecks”.

For long-distance passenger transportation the tariff include: car, infrastructure, locomotive and terminal elements. A carrier pays “Russian Railways” for infrastructure and railway terminal. At the same time, from 2011 99.9% of the infrastructure payment for commuter passenger transportation “Russian Railways” receives from the federal budget and 0.01% - from commuter carriers.

In FAS opinion, the structural division in the freight and passenger segments will make the fee for access to the infrastructure more economically justified and transparent.

Since the fee is set by the regulator (the Federal Tariff Service) no violations on discriminatory tariffs were revealed before 2013. In 2013 the regulator set the minimum and maximum levels of freight prices, so it is possible that “Russian Railways” would fix discriminatory tariffs. Such tariffs can be investigated for compliance with the antimonopoly law upon petitions from consumers in Russia, Belarus and Kazakhstan.

Investments in railway infrastructure in the Russian Federation

Making decisions on investing in the railway
Infrastructure in Russia takes several stages. A carrier (an infrastructure owner) drafts an investment plan to be discussed with the representatives of the Government of the Russian Federation. Each body analyses a project within its competence: the Ministry of Economic Development evaluates macro- and micro-economic effects; the Ministry of Transport – the long-term goals of industry development, while the Federal Tariff Service verifies the tariffs. Upon approval by the Government an investment plan is adopted by the Board of Directors of “Russian Railways”.

Investments in railway infrastructure are made from the funds of:
- The state (federal budget)
- “Russian Railways” (company’s own funds)
- Private sector (infrastructure projects).

Infrastructure projects with combined state-private investments are being discussed (for instance, a railway road connecting Tuva to Krasnoyarsk region and the national railway network).

Efforts are made to draft the legislative network for increasing the share of private investments in infrastructure development. The Road Map for “Developing Competition and Improving the Antimonopoly Policy” includes measures for modernizing the legislation in the part of long-term tariffs for the services of the holders of natural monopolies in the railway transport.

The main aims of the long-term tariff policy are:
- Developing infrastructure facilities in natural monopolies and adjacent markets
- Establishing sustainable, favourable conditions
for attracting investments in construction of production facilities
- Developing the mechanisms of increasing attractiveness of investment projects by the state in the infrastructure sectors of the economy.

In FAS opinion, differentiating tariffs for segments of the infrastructure in general use will facilitate infrastructure development and eliminate bottlenecks:
- Reduced tariffs for private investments, if the costs of use of the borrowed funds are compensated by reduced freight tariffs for carrying out works (rendering services) to the investors
- Increased tariffs if financing is provided by the subject of regulation or private investors and the investments, including the borrowing costs, are compensated through increased freight tariffs for works (services) to economic entities that are not the investors.

High-speed railway transportation in Russia

High-speed railway transportation is underdeveloped in Russia. In fact, there is no high-speed railway communication with specialized infrastructure and other typical attributes (like, for instance, in the EU, the USA, or Japan).

High-speed railway transportation (more than 200 km/h) is exercised on two routes:
- Moscow - St Petersburg – Moscow, the maximum speed reaching 250 km/h, the sole carrier is “Russian Railways” (launched in December 2009)
- Helsinki - St Petersburg — Helsinki, the maximum speed reaching 220 km/h, the sole carrier Oy Karelian Trains Ltd, a joint venture of Suomen Valtion Rautatiet (VR) (Finland) and “Russian Railways”.

Since high-speed trains use the same infrastructure as freight and passenger transportation, albeit
modernized (with funding from private sector and “Russian Railways”), they hamper the traffic of inter-city and commuter trains. The tariffs for high-speed transportation are not regulated.

Due to lack of modernized and specialized infrastructure new carriers do not enter this segment, although it is open to competition. High speed trains compete with airlines (competition between the means of transport) and with trains of other carriers, for instance, “FPK” OJSC on the same routes (competition within the railway industry).

The concept of high-speed railway transportation with specialized infrastructure and other typical attributes has been discussed by the Government for the past few years. It is included in 2030 Transport Strategy. The maximum speed should reach 350—400 km/h. Constructing a high-speed line between Moscow and Kazan by 2018 is under discussion (with a prospective extension to Yekaterinburg), and at a later stage - a high-speed Moscow – Rostov-on-Don – Adler line. It is estimated that the Moscow – Kazan line will cost 928 billion RUB. 176 billion RUB will be allocated from the National Wealth Fund and 371 billion RUB – from the budget (at the stage of construction) and then 179 billion RUB (at the stage of operating the line). Financing from the National Wealth Fund can be increased if a decision is made on tax benefits for the project company, the state funding will be decreased.

CONCLUSIONS

The history of the reforms of Russian railways sector is over 15 years. Due to the structural measures started in 2001, “Russian Railways” was formed; the market of freight cars liberalized; passenger traffic by compartment and first-class cars deregulated; and many non-core activities and facilities of private industrial railway infrastructure underwent corporatization and privatization. As a result, competition is present in the railway industry to a certain extent in both freight and passenger transportation.

Competition between freight operators is highly developed. At the same time, in FAS opinion, introducing and advancing the institution of alternative carriers will further support competition in this sector. In passenger transportation competition is developing in the inter-city and commuter segments due to deregulation, including competition between different types of transportation (inter-city, commuter, enhanced-comfort commuting).

Competition between the means of transport exists in freight as well as passenger sectors. The share of railway freight traffic has remained stable in the recent years. The strongest competitor is road transportation although its share in total freight turnover is still not very high (10%). In passenger transportation the strongest competitors are air and road transport.

FAS believes that commercial market infrastructure, flexible pricing, including stage-by-stage freight deregulation on particular routes, “dynamic pricing” depending on a season and demand, etc., shall help achieve the balance of interests between consumers and railway companies, enabling high quality, affordable services for consumers and efficient performance and development of market participants.

The current freight tariff policy does not fit the modern market economy and must be reconsidered, in particular, to increase transparency of railway tariffs, and observe the balance of interests between consumers and natural monopolies.

There are no tender procedures in the Russian Federation for determining passenger carriers. FAS trusts that such procedures can be introduced subject to compliance with the relevant legislative standards and rules.

The fee for access to the infrastructure of the railways in general use is charged differently for freight and passenger traffic due to specifics of the tariff elements. FAS believes that the existing structural division means more transparent and economically justified fees.

Investments in the railway sector are mostly made by the state and “Russian Railways”. It is important to develop the institution of private investments. A “long-term tariff policy” can be one of the instruments encouraging such developments.

Russia needs high-speed passenger transportation: it will support competition in the railway industry and stimulate competitive ability of railway transport in comparison with other means of transport. However, it should be achieved by creating appropriate infrastructure, rather than to the detriment of traditional passenger and freight traffic.

Developing the railway industry generates a multiplier effect in the national economy.

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SPECIFICS OF DEVELOPING COMPEITION ON THE MARKETS OF WEAPONS AND MILITARY EQUIPMENT

The strategy for developing defence industry in the Russian Federation includes considerable increase of budgetary expenditures for purchasing weapons and military equipment. By 2016 defence expenses should reach around 20% of the budget.

Efficiency of the expenditures for the military industrial complex (MIC) will depend directly on the economic strategies of defence companies, which, in their turn, depend on the institutional environment and a level of competition development. Under weak competition, attempts to inject funds in the military industry will generate mostly redistribution effects rather than development of sectors and military equipment at a new level. Therefore supporting competition on potentially competitive MIC markets is one of the most important objectives of the national policy.

Through decades Russia has been ranking the second on the global market of military equipment after the USA (the market share 35—40%). In 2011 weapons supply from Russia reached, according to various estimates, 17 - 23% of the global weapons market. Russia supplies to 60 countries, the main importers of MIC products in 2011 were Afghanistan, Algeria, Argentina, Armenia, Brazil, Chad, China, Congo, Cyprus, Ecuador, Egypt, India, Indonesia, Iran, Iraq, Kazakhstan, Kuwait, Venezuela, Vietnam, Thailand and Syria.

GENERAL TRENDS

The most important export segments are: aviation (Su-27, Su-30, MiG-29 fighters competing with American F-16, F-18, F-22; Ka-50, Ka-52, Mi-8, Mi-17 helicopters); armor (T-72, T-80, T-90 tanks; BMP-2, BMP-3, BTR armored vehicles); anti-aircraft defence (S-200, S-125, S-75, C-300PMU, Top-M1 air defence missile systems); and navy equipment.

Currently around 1700 companies and organizations are involved in defence manufacturing. In most cases up to 85% of the equipment were made more than 10 years ago, and around 60% - more than 20 years ago. Plummeting weaponry procurement in the 1990s, a difficult financial position of defence companies resulted in a significant outflow of specialists from the industry and drastic cuts in R&D funding. It explains an insufficient level of competitive ability of Russian equipment (especially taking into consideration the entire life cycle) in spite of a wide range of products and relatively low prices.

Competitors-Restricting Factors

Nearly all MIC sectors have a low level of competition due to objective as well as subjective factors.

Objective factors include:
- High administrative and economic market entry barriers. (This factor is more pronounced in end product manufacturing and is less evident for particular components, units, assemblies, raw materials and supplies)
- Product development and testing for serial production and supply are time- and materials consuming
- Relatively low demand for the products, insufficient to achieve economy of scale by several manufacturers.

Subjective factors comprise:
- Traditional cooperation between independent economic entities breaking which require considerable material costs and time – "fundamental transformation"
- Restrictions for use of foreign-made parts to manufacture military equipment under government defence
- Specifying particular characteristics of components or their manufacturers in the design documentation (technical assignment) by the principal product

engineer (or the ordering party), changing which would require additional testing and approvals

- Price regulation of sole suppliers using the cost plus method, which decreases the incentives for principal executors to minimize the costs and stimulate competition among their suppliers.

These factors have a different impact depending on a stage of production cycle and the level of cooperation (Table 1).

<table>
<thead>
<tr>
<th>Production cycle</th>
<th>High market entry barriers</th>
<th>Relatively high costs of launching a new product</th>
<th>Economy of scale</th>
<th>High switching costs</th>
<th>Import restrictions</th>
<th>Specifying suppliers in the documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finished products</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Parts, units, assemblies</td>
<td>+</td>
<td>+/-</td>
<td>+/-</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Raw materials and supplies</td>
<td>+</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>+/-</td>
<td>+/-</td>
</tr>
</tbody>
</table>

Note: + strong impact; +/- low impact; – no impact

1 The above restrictions can be eliminated only by reducing administrative market entry barriers, creating favourable conditions for financing projects on developing new models of military equipment, materials and at the same time can authorize competitors’ entry to the market, which inevitably generates a conflict of interests. This approach to regulating the quality of military equipment, components and materials for its production not only helps particular economic entities eliminate market competition but also erodes responsibility for defective products between the ordering party, manufacturer, principal design engineer on the one hand, and a “sectoral research institute” on the other.

The strategy for developing the military-industrial complex in the Russian Federation in the past decade included creating vertically-integrated structures that comprised economic entities operating on the same as well as on adjacent markets. Depending on the market specifics, vertically-integrated structures can be associated with adverse (deteriorated competitive environment) as well as positive consequences (economy of scale, reduced transaction costs, etc.)

A positive effect of vertical and horizontal integration (especially under limited competition due to cooperation) in the form of optimizing and reducing the costs compensates the losses from restricted competition only if there is international competition on the end product market, because manufacturers have incentives to minimize the costs and innovate, and transactional costs can be decreased considerably. In the absence of external competition, optimization can be made possible through developing competition on the markets of components, raw materials and supplies.

Therefore, vertically-integrated structures in MIC should be considered in terms of the balance of benefits from economy of scale and minimization of transactional costs against the costs of restricted competition.

**INSTRUMENTS FOR DEVELOPING COMPETITION ON DEFENCE MARKETS**

The above restrictions can be eliminated only by reducing administrative market entry barriers, creating favourable conditions for financing projects on developing new models of military equipment,
correcting the system of state procurement (to involve the maximum number of participants at the stage of developing models of military equipment), expanding demand for the products supplied under government defence procurement, and achieving predictability (the latter is a necessary condition for developing defence sectors).

These measures are designed, on the one hand, to form incentives for the market participants to work on competitive developments of new models of military equipment, and on the other – to stimulate export of weapons and implementation of military solutions on the markets of non-defence products to ensure efficient use of production capacities of defence companies (Table 2).

### Examples as to How Industry Consolidation Influence the Markets

#### Example 1

An example of a positive effect from industry consolidation is establishing a vertically-integrated structure in the helicopter sector. *Russian Helicopters* consolidated all helicopter plants in the Russian Federation, several design bureaus, manufacturers of component parts, and companies providing support services. Thus, a vertically integrated structure combined both horizontal and vertical industry integration.

Establishing the new holding completely eliminated competition between previously independent manufacturers and design bureaus, which could have led to reduced efficiency of market players’ performance and decreased incentives to innovate across the industry. Nevertheless, Russian helicopter industry shows the opposite trends due to intensive competition on the international market of helicopter equipment and significant export of industry products (in comparison with domestic consumption), losing which can have an critically adverse impact upon Russian helicopter companies.

**The global market.** There are about 150 manufacturers of helicopter equipment; about 85% of the global market are controlled by six players. *Bell HelicopterTextron* (USA) is the market leader by the number of manufactured helicopters - 23%. Next are *Eurocopter* (Europea) – 18-19%, *Russian Helicopters* - 13—14%, and *Sikorsky* (USA) - 12%. Russian company is present in all market segments; it has the leading positions in the segments of medium-heavy, ultra-heavy and attack helicopters in the global markets and it is the leader in the markets of the CIS and emerging markets.

### Table 2. Measures for supporting competition in defence sectors

| High market entry barriers | Reducing administrative entry barriers: the authorities must be directly prohibited to assign functions for product licensing to the market participants. Devising state programmes for joint financing of development of new models of military equipment. Devising state programmes to co-finance modernization of production capacities and investment projects in priority defence sectors. |
| Relatively high costs of launching new products | Devising state programmes to co-finance development of new models of military equipment. |
| Economy of scale is unattainable | Expanding demand for defence products – stimulating implementation of military solutions on the markets of non-defence products. Simplifying the procedures for export of weapons and military equipment, components. |
| High switching costs | Stimulating head executors to extend a list of potential suppliers (their products) included in the design documentation at the stage of developing models of military equipment: co-financing additional testing necessary for including alternative suppliers (their products) in the design documentation. Creating vertically-integrated structures in the absence of potential competition between suppliers of raw materials, supplies and competition on the markets of end product. |
| Restrictions for imported products | Replacing strict restrictions for use of imported analogues with customs and tariff restrictions (except the strategic sectors of the military defence complex). |
| Specifying suppliers in the engineering documentation | Directly prohibiting to specify a sole supplier (or a particular product) in the engineering documentation for the end product if this element of the end product is not a critical component, or it is possible to describe its technical, operational and other significant characteristics. |

**The global market.** There are about 150 manufacturers of helicopter equipment; about 85% of the global market are controlled by six players. *Bell HelicopterTextron* (USA) is the market leader by the number of manufactured helicopters - 23%. Next are *Eurocopter* (Europea) – 18-19%, *Russian Helicopters* - 13—14%, and *Sikorsky* (USA) - 12%. Russian company is present in all market segments; it has the leading positions in the segments of medium-heavy, ultra-heavy and attack helicopters in the global markets and it is the leader in the markets of the CIS and emerging markets.
The competition strategy of Russian Helicopters. The key indicators for evaluating the competition strategy are: changes in the market share, extending the presence on new markets, extending the presence within new geographic boundaries; trends in expenses for R&D and modernization of production capacities.

In 2011 Russian Helicopters supplied 262 helicopters, which is 22.4% more than in 2010. The company’s share of the world market in 2011 increased by 0.5%, reaching 14.0%. The revenues from services and after-sales support increased to 15 billion Rubles, making 14% of the total company revenues.

Russian Helicopters actively opens up new product and consumer markets. In 2010—2011 supplies of helicopter to India and China increased considerably, the company concluded a contract and supplied the first consignment (9 helicopters) to the US Army, entered the markets of Brazil and Argentina. A new product is launched into the market – middle non-defence Мi-38 helicopter for passenger transportation.

In 2010—2011 the main financial indicators were increasing: revenues for 2010 went up by 42.1%, in 2011 – by 27.8%; EBITDA grew by 27.2% in 2010 and by 31.7% in 2011 accordingly. In 2011 expenses for R&D increased by 2.7 times and investments in production capacities reached 65.5%.

Therefore, Russian Helicopters pursues an active competition strategy even in the absence of competitors in the Russian Federation.

These examples prove that restricted competition can have different effects upon markets of military equipment. If international competition is well-developed, restricting competition on the markets of parts, raw materials and supplies leads to a redistribution effect rather than withholdings from GDP, because the pressure of competition on the market of end product partially levels adverse consequences on the adjacent markets.

Example 2
In 2011 FAS found that Alcoa Group of persons violated the Law “On Protection of Competition” by fixing monopolistically high prices.

The market. Alcoa SMZ is the only manufacturer of AMr6M sheets thinner than 2mm in Russia, while Alcoa Metallurg Rus is the only Russian manufacturer of AMr6M sheets thicker than 2200 mm (up to 3150 mm). The companies are members of the same group of persons with Alcoa (USA). Consumers use the goods for production purposes under government defence procurement and federal target programmes.

Excessive prices for monopolistic products. FAS established that in 2009 the rate of price increases by Alcoa Metallurg Rus for AMg6M aluminum alloy sheets was 119.3%, exceeding the rate of price growth for comparable aluminum products by 60—70%. Having analyzed the data on output, fixed costs, and the production costs structure for similar products, FAS concluded that the Alcoa Group drove up prices for monopolistic products by more than 50%.

This example illustrates that vertical and horizontal integration in defence industry can lead to considerable positive effects without substantial adverse consequences determined by a deteriorating competitive environment in Russia. Such effects are possible on the markets with developed international competition, when participation in international markets is critical (first of all, due to the ratio of domestic and external demand) for industry performance.

Without the pressure of external competition market monopolization can have severe adverse impact such as a growth of prices for the products for the needs of defence industry, declining investments, etc. An example is consolidation of manufacturers of rolled products for the aviation industry.
The antimonopoly regulation is Russia is approaching a new reform. In particular, the changes can touch on regulation of a civil law institute — the rights for the results of intellectual activity\(^1\).

Section 6 of the “Road Map” for “Developing Competition and Improving the Antimonopoly Policy” includes such measures as “protecting the interests of economic entities in exercising actions and concluding agreements on enforcing exclusive rights if such actions and agreements lead or can lead to preventing, restricting, eliminating competition”. As a goal, the Road Map authors see “absence of incidents of restricting competition with use of exclusive rights”.

It enables making two important conclusions. First, the Road Map does not predetermine what kind of amendments should be made to the law: its general statements give room for proposing various measures. Second, the amendments proposed to the Law “On Protection of Competition” to implement the Road Map by definition will bring principal changes to the present regulation of intellectual property by the antimonopoly law.

In this paper we analyze the relevance and practicability of the proposed amendments to the competition law. The following amendments are put forward:\(^2\):

1) Add Part 3 to Article 3 as follows: “Provisions of this Federal Law shall apply to the relations associated with circulation of goods produced using exclusive rights items if agreements (actions) related to use of exclusive rights items are aimed at preventing, restricting, eliminating competition”

2) Clause 1 Article 4 formulate as follows: “goods — an object of civil rights (including, works, services, particularly, financial services), except protected results of intellectual activity and similar means of individualization (intellectual property) designed for sale, exchange or other introduction into circulation”


The proposed amendments (except clarifying the concept of “goods”) do not take into account the RIA nature and, unfortunately, considerably restrict protection of the rights holders.

General Antimonopoly Control – Extending to RIA

The rights for the results of intellectual activity are absolute, exclusive. A holder of exclusive rights can exercise any actions with RIA not directly prohibited by law; RIA rights gives a holder of exclusive rights a “legal monopoly” formalized by law.

The Constitutional Court of the Russian Federation (No.171-0 Definition of 22.04.2004) characterized prohibition of use of a trade mark by other persons as restriction aimed at enforcing Article 44 (Part 1) of the Constitution of the Russian Federation, which restricts that rights of economic entities under Article 34 of the Constitution of the Russian Federation to the extent that is necessary under Article 55 (Part 3) in order to protect the health, rights and legitimate interests of other persons. Hence, an exclusive right is a legal monopoly.

The legal nature and legal registration of such rights predefine certain restrictions, like the period and geographic area of protection, prohibition to use RIA by the third parties without consent of the rights holder. Actions for exercising exclusive rights and agreements on granting and (or) alienating the right to use intellectual property results are exempt from antimonopoly regulation under Part 4 Article 10 and Part 9 Article 11 of the Law “On Protection of Competition”.

If these exemptions are removed from the Law, the third parties will always be able to challenge exclusive rights under the Civil law through the antimonopoly authority (including potential violators of RIA rights) because exclusive rights by definition have elements of restricting competition. For instance, granting a license to a particular company and refusing another one fall under “reducing the number of economic entities that are not members of the same group of persons on the market” It would considerably decrease attractiveness of Russia as a jurisdiction with favourable regime of protecting innovative manufacturing methods.
Abroad, the issue of restricting competition as a result of exclusive rights is primarily investigated in the pharmaceutical and medical products sector. Remember, for instance, such high-profile cases as Generics (UK) Limited v. Astra Zeneca (UK) Limited (Astra AB), IMS Health GmbH & Co. OHG v. NDC Health GmbH & Co KG, and a recent ruling of the US Supreme Court on a case Federal Trade Commission v. Actavis with regard to a pay for delay agreement.

In Russia pharmaceutical companies are frequently held administratively liable, particularly, for abusing market dominance. A strong example is a case against “Novo-Nordisk” Ltd. For several years the company had the dominant position on the wholesale medicine market which raised an issue of regulating access to such goods for the largest federal distributors. Obviously, the “Novo-Nordisk” case concerns circulation of goods produced with use of exclusive rights items. However, the problem of using the results of intellectual activity as well as the fact of the pharmaceutical company possessing such results were not raised during the antimonopoly investigation.

Analyzing the goal of the new norm, it seems that the key part of it, which, in our opinion, brings the adverse effect, is evaluating agreements and actions with use of exclusive rights items to identify classic signs of preventing, restricting or eliminating competition. In other words, it means introduction of antimonopoly control over various licensing agreements (from licensing trademarks to transferring patent rights).

Principal “pro” and “contra” arguments should be based on objective characteristics of Russian market and Russian legal system. References to precedents in other countries and, moreover, desire to plant the institutions of foreign law in Russian legal system are secondary arguments that cannot play the decisive role.

The major arguments against expanding Articles 10 and 11 of the Law “On Protection of Competition” for actions and agreements with use of exclusive rights are as follows:

1. Considerable specifics of every intellectual property item with regard to goods in general as well as other intellectual property items. Problems in different fields, for instance, use of trademarks (parallel import and a national principle of rights exhaustion), exercising patent rights, or commercial concession contracts require different solutions. Expanding the Law “On Protection of Competition” to such rights in general in the absence of special antimonopoly rules for each of such items by definition cannot resolve any of real or theoretical problems.

2. Characteristics of Russian economy – on the one hand, a considerable share of imported goods, and on the other – trends towards localizing production. It seems that a more reasonable balance of interests in protection and restriction of the rights for trademarks will not make Russian market less attractive for foreign producers and will not have an adverse impact upon import (perhaps, quite the opposite). However, restricted patent rights can undermine the probability of transferring production and R&D centres of the leading companies to Russia and deteriorate the conditions for Russian business accessing innovations. The risk of antimonopoly intervention in licensing agreements...
between independent persons will be compensated by refusing to grant licenses outside the group of persons of the rights holder (since antimonopoly prohibitions are not applicable within a group of persons)⁴.

3. Specifics of Russian Law “On Competition Protection”. On the one hand, a low threshold for recognizing market dominance (in some cases below 10%) and an open list of abuses of dominant market position highly increase the probability of antimonopoly claims against a wide range of RIA rights holders. On the other, due to an overall insufficient level of studying the problem of the “signs of restricting competition”, a limited number of cases when the rule of reason is applied to agreements between economic entities (Article 11) increases probability of errors in future RIA enforcement practice. For small and medium innovative companies such errors can become a formidable obstacle for commercializing an innovative product, attracting a strategic investor or project financing.

Thus, the practical value of the proposed amendments to the Law is not that obvious as it may seem at the first glance.

Practice of Antimonopoly Regulation in the USA and the European Union

Analysis of antimonopoly law and enforcement in foreign jurisdictions shows that expanding antimonopoly regulation to the relations involving the results of intellectual activity is rather limited. Typically, such cases include refusals to grant licenses; essential facilities/SEP (particular, in the field of “high technologies”); other situations of evident abuse of rights by the rights holders.

Let’s look at some most important recent disputes. **AB Volvo v. Erik Veng (UK) Ltd**⁷

*Volvo*, being a possessor of the rights, registered in an EC member-state, for production prototypes and models (designs) of car nodes and components undertook some measures to prevent production and distribution of similar details by the third persons in the EC, refusing to grant licenses for its prototypes. EU Court of Justice ruled that if a company is obligated to grant licenses for production and supplying spare parts, fabricated using production prototypes and models owned by the company, to the third parties is means depriving the company of its exclusive rights so a refusal to grant licenses cannot by itself constitute abusing market dominance. *Volvo* was able to prove that refusals to grant licenses were not arbitrary (the licenses were not granted to the third parties in principle.

**Microsoft Corporation v. European Commission (the case was opened upon complaints from Novel and Sun Microsystems)**⁸

The company restricted access to information about *Microsoft Windows* operational environment (descriptions of *Windows* protocols), as a result of which software developers were unable to achieve compatibility of their products with *Windows* platform that dominated the market.

The case was based on a legal position that patents, copyrights and other exclusive rights possessed by *Microsoft* could not by themselves exclude an intervention from the European Commission. At the same time, the decision on the case consolidated a legal principle that a refusal to grant a RIA license by the dominant economic entity does not by itself constitute an antimonopoly violation. The European Commission referred to a number of exceptional circumstances that justified its intervention.

*Microsoft* is a “quasi-monopoly” with the market share close to 100%. With such market power, the company can use any program languages, protocols, etc., and they automatically become the industry standards since other software vendors must ensure compatibility to be able to sell their products to *Windows* OS users, who form the absolute user majority⁹.

It leads to two essential conclusions. **First**, not every economic entity with exclusive rights falls under antimonopoly control. In theory, such control is justified only if a company has a quasi-monopolistic position on the market.

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⁷ See Clause 464 of the decision issued by the European Commission.
⁸ The full text of the Commission decision is available at http://ec.europa.eu/competition/antitrust/cases/doc_docs/37792/37792_4177_1.pdf
**Second**, even if a quasi-monopolistic position is established, not every RIA can be recognized as restricting competition, only when the issue is providing access to the industry standards. De facto, such standardized protocols constitute essential facilities.

In the Microsoft case the question was about licensing access to protocols—a small but essential part of a software code but not to Windows operational system (its modifications or parts), that would enable creating a competitive, independent software environment on the basis of Windows OS. The European Commission repeatedly stated that it does not require providing access to the Windows code or transferring a Microsoft software product to company's competitors.

A general European approach was applied that a person dominating the market is not obligated to grant licenses for RIA owned by this person. Licenses must be granted only if refusals to grant them to competitors can eliminate competition on the relevant market in principle.

Thus, a more detailed study of this case, that many analysts consider iconic, does not presume a concept of unlimited control over RIA circulation.

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**Conclusions**

The above examples illustrate that unlimited antimonopoly enforcement in the field of RIA rights is not applied in the international practice as a solution to balancing the antimonopoly law and intellectual property rights.

In Russian economy and enforcement practice the issue of abusing RIA rights in general is less acute and has several specific characteristics. Thus, the amendments to the Law “On Protection of Competition” that expand some antimonopoly prohibitions to exclusive rights seem ill-timed.

A more efficient approach can be point solutions to the most widespread problems by devising the rules for innovative / technology markets and particular types of RIA on the basis of the existing Civil Code.

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See Clause 572 of the decision issued by the European Commission.

See Clause 546 of the decision issued by the European Commission.
ABUSING LEGAL MONOPOLY OF INTELLECTUAL PROPERTY RIGHTS HOLDER AS A SUBJECT OF ANTIMONOPOLY REGULATION

Clause 6 of the Actions Plan (“Road Map”) for “Developing Competition and Improving the Antimonopoly Policy” approved by the Government of the Russian Federation on 28.12.2012 requires, in particular, devising and legislatively formalizing a legal mechanism for protecting the interests of economic entities that exercise actions and conclude agreements on enjoying the exclusive rights, if such actions and agreements lead or can lead to preventing, restricting, eliminating competition. It will be an important step towards harmonizing Russian antimonopoly law in line with the best international practices.

In the European and North American legal science applying the norms of the antimonopoly law to intellectual property is already a statement of fact rather than a discussion of an emerging trend. Developed foreign countries have accumulated the relevant enforcement practice, and concluded international agreements enabling application of antimonopoly standards to legal relations in the field of intellectual property.

One of the most important is the Agreement of Trade Related Aspects of Intellectual Property Rights (TRIPS) included in the regulatory framework of WTO, that the Russian Federation recently joined. Article 40 of TRIPS clearly states that the countries – signatories to the Agreement acknowledge the fact that some types of licensing practice and conditions related to intellectual property rights can directly restrict competition and, as a consequence, have adverse impact upon trade, particularly, by preventing transfer and dissemination of technologies. At the same time, Part 2 of TRIPS enables the member-countries to independently formalize in their national laws the types of licensing practice that can constitute abusing intellectual property rights and have an adverse impact upon competition in a relevant market, and as the measures towards suppressing such practices use, for instance, the

requirements for reverse transfer of technical information by a license buyer to the seller, or a mandatory package of licensing conditions.

Russia becoming a WTO member constitutes the grounds for implementing the key provisions of the fundamental Agreement in the field of intellectual property into the norms of Russian antimonopoly law.


In particular, the above Guidelines contain the following important provisions:

- The rights holder can be recognized a having the dominant position if a patent was used by the rights holder to produce particular material goods, or the goods are unique and do not have substitutes
- Markets of technologies and innovations (R&D) must also be classified as goods markets; technologies and innovations constitute a category of goods
- Licensing agreements concealing cartels on fixing and maintaining prices, and dividing the market are prohibited per se
- Tying arrangements are prohibited
- Grantback is prohibited if it prevents developing technology and innovations by a licensee
- Patent pools are prohibited if such agreements fix the price of the products produced using patents
- “Safety harbours”: allowing licensing agreement that do not have direct anticompetitive restrictions and have a positive effect upon competition between technologies and R&D, or if there are more than 4 substitute technologies developed by other market actors with similar licensing payments.

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According to the Guidelines, abusing dominance can take place by the rights holder unilaterally affecting the general conditions of goods circulating on the market, preventing development of the market in question and the adjacent markets. A good illustration of the outlined concept of applying the antimonopoly rules to the actions of rights holders is a case the European Commission v. Microsoft Corporation. The European Commission found that a refusal of Microsoft Corporation to enter into licensing agreements on the intellectual rights for an operational system (OS) contradicted the antimonopoly norms of the Treaty of Rome. Obtaining an access to OS other companies would be able to develop Windows-compatible software that would be able to compete with Microsoft programs.

To implement the best international practices into Russian antimonopoly law, Part 4 Article 10 and Part 9 Article 11 must be removed from No.135-FZ Federal Law “On Protection of Competition” of 26th June 2006, specifying that the Law is applicable to the relations on circulation of the goods produced using exclusive rights for the results of intellectual activity, if agreements (actions) related to use of exclusive rights are aimed at preventing, restricting or eliminating competition in circulation of the goods in question.

In this case, the antimonopoly standard must apply to the circulation of a product obtained by using a patent or marked with a trade mark: for use of exclusive rights in the products rather than the exclusive rights themselves.

The antimonopoly rules should also be expanded to the agreements on granting the rights for use of intellectual property items. For instance, currently a licensing agreement regarding a trade mark can fall under all types of agreements prohibited by Article 11 of the Competition Law, particularly, “vertical” agreements that have “anticompetitive” consequences or include “anticompetitive” conditions (Part 2, 4 Article 11): fixing resale prices, an obligation not to sell the goods of competitors of the trade mark owner, other disadvantageous contract conditions (for example, an obligation to buy goods, which are irrelevant to the license, from the rights holder).

The proposed amendments to the antimonopoly law do not contradict with the Civil Code of the Russian Federation. Exclusive rights for such items belong to civil rights and are of a complex nature, including both property and personal non-property rights (for instance, copyrights).

Under Article 1229 of the Civil Code the rights holders can at their discretion allow or forbid other persons to use the results of intellectual activity or means of individualization. At the same time, Article 10 of the Civil Code prohibits use of civil rights for restricting competition and abusing the dominant market position. This prohibition is universal, without exceptions for the results of intellectual activity or similar to them means of individualization.

Thus, since the Civil Code classifies abusing exclusive rights for intellectual property items for the purposes of restricting competition and abusing dominance as violations, they also constitute violations of the antimonopoly law.

Moreover, the Civil Code directly provides for applying the antimonopoly law to agreements in the field of intellectual property. In particular, Article 1033 of the Civil Code directly states that restrictive conditions of such agreements can be recognized invalid upon a request of the antimonopoly authority or another interested person if such conditions, in view of the state of the relevant market and the economic position of the parties, contradict the antimonopoly law (for instance, an obligation of a user not to compete with the rights holder on the territory, covered by a commercial concession agreement with regard to business activities exercised by the user based on the exclusive rights that belong to the rights holder; an obligation of a user to dispose of, in particular, resell produced and (or) purchased goods, carry out works or render services at the prices, set by the rights holder, using the exclusive rights that belong to the rights holder).

Therefore, the Law “On Protection of Competition” must be adjusted in line with the Civil Code.

In conclusion, prohibitions of using intellectual rights to restrict competition established in the antimonopoly law of foreign countries, have not generated outflows of investments and the risks of weakening legal protection of intellectual property, or collusions between the civil and antimonopoly laws.

Thus, expanding the antimonopoly rules to the exclusive rights is a trend that must be accepted and developed, building up a balance between legislative protection of intellectual property items and inadmissibility of abusing intellectual rights for the purposes of unreasonable and unfair restrictions of competition.

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2 Further on referred to as the Competition Law.
3 Further on Referred to as the Civil Code.
CLASS ACTIONS: TO BE OR NOT TO BE?

The legal community in Russia had a “hot” summer in 2013 as a draft Law “On Introducing Amendments to Some Legislative Acts of the Russian Federation (On Introducing Amendments to Some Legislative Acts of the Russian Federation in the Part of Regulating the Procedures for Considering Cases on Protecting the Rights and Legitimate Interests of a Group of Persons (Class Actions))” was presented¹.

The paper analyzes the main provisions of the current version of the draft Law, identifies the most serious risks and outlines the possible methods of eliminating them to harmonize integration of the new institution in the existing system of legal standards.

HISTORY AND A BRIEF DESCRIPTION OF THE MAIN PROVISIONS OF THE DRAFT LAW

The draft Law was discussed by the Inter-Departmental Working Group at the Government Commission for Competition and Developing Small and Medium Business in order to improve the existing provisions on class actions to enhance consumer protection.

The draft Law brings amendments to the Civil Code, the Tax Code, the Arbitration Procedural Code and the Civil Procedural Code of the Russian Federation, the laws on consumer protection, competition, and protection of the rights and legitimate interests of investors in the securities market. It introduces the concepts of “success fee”, “potential damages” and “class actions”, establishes class actions procedures and formalizes the grounds for recovering potential damages.

Arbitration Courts can consider class actions on corporate disputes, disputes related to professional activities of participants of securities markets, banking and investments subsequent upon antimonopoly violations, and other cases specified by the federal law. Therefore, disputes between banks and their borrowers who feel injured through loan contracts can be considered as class actions.

THE MAIN PROVISIONS OF THE DRAFT LAW BEARING RISKS FOR THE BUSINESS COMMUNITY

Let’s analyze class actions models and possible abuses by unfair plaintiffs that initiate class actions

Opt-out v. opt-in

The draft law allows collecting potential damages by a group of persons who can form the same group with a claimant but do not raise claims through judicial procedures (do not join the action): the opt-out model. It generates a threat of recovering considerable damages determined only by the number of potential group members.

To determine the size of a group in class actions, the draft Law requires “uniformity of the subjects and the grounds for the claims of members of a group of persons”. A literal interpretation leads to a conclusion that a group can comprise “groups” that have various contractual relations with a potential respondent or do not have such relations at all (contractual and delictual liability). For instance if a respondent is a manufacturing company then all legal entities included in the distribution chain and consumers - physical persons can be plaintiffs in a class action.

It becomes possible because physical and (or) legal persons can be included in a group. Representatives of both categories can be united under the criteria of the uniformity of the subject and the grounds of a claim: dealers that purchased products from a producer to sell it (legal entities) and physical persons who bought the product in retail for personal needs. Other criteria and an overall tone of the draft Law lead to a conclusion that it is possible to combine the claims of such physical and legal entities to the same respondent in the same action.

In the US, where the opt-out model originated, there is a direct purchaser principle: only direct rather than indirect purchasers can bring actions for price collusion (IllinoisBrickCo. v. Illinois - 431 U.S. 720 (1977))\(^2\). Competitors can claim damages only if violating the antimonopoly law by a respondent inflicted losses upon them.

The European Union made a conceptual decision not to apply the opt-out model to avoid the above shortcomings and the risk of unfounded actions as well as other abuses.\(^3\) The Directive on damages claims for violating EU antimonopoly law and the Guidelines on class actions propose an opt-in model, when only a person that declared an intention to join the action can be a group member\(^4\). Some European economists believe that not all potential group members incur damages since the costs generated by increased cartel prices are not always shifted to consumers\(^5\).

Integration of the institution of class action will be more harmonious if Russia, a country with a continental law system, adopts the European experience. Recovering damages is a civil liability; one of its attributes is that sanctions must correspond to the inflicted damages or losses (a compensatory measure).

The draft Law proposes a method of “approximate estimates” of “possible average” damages. It means that the sum of compensation to be paid by a respondent is estimated approximately and can exceed the real damages. It contravenes Article 15 of the Civil Code, that a respondent must compensate only the losses caused by a violation (including the real damages and loss of expected gain).

In the Law, it would reasonable to use the opt-in system and clarify the criteria for defining a group of persons that exclude, for instance, involvement of legal entities that do not have direct contractual relations with a respondent to a class action\(^6\).

### THE BALANCE OF INTERESTS OF POTENTIAL PLAINTIFFS AND RESPONDENTS

The draft Law does not maintain the balance of interests of potential plaintiffs and respondents, of which unfair persons can take advantage initiating class actions to obtain unfounded payments.

An undetermined circle of group members and minimum costs or absence of costs necessary to initiate class actions inevitably will lead to abuse of rights. The risks of abuses are related to several factors: a relatively low, in my opinion, threshold for recognizing a claim as a class action (16 persons in an arbitration process, and 31 - in a civil process); prolonged periods for class actions consideration; possibility to charge a respondent a “success fee”; relieving plaintiffs from state levy (in civil proceedings); selective application of the rule of reason to compensate judicial costs if a claim is dismissed, etc.

Information about multimillion class actions against public companies listed at Russian or international exchanges can have a significant adverse effect upon the price of shares. Reputational risks and potentially high stated claims will force respondents to settle upon unreasonable and unproved claims.

“Success fee” can be a clear incentive for unfair representatives of legal communities to initiate class actions since its size it determined by an agreement between the parties (a group of plaintiffs and an attorney). If a claim is allowed, plaintiffs have the right to collect the fee from a respondent. The court costs can be estimated in line with the current market rates and judicial recovery practice, while it is not possible to calculate a “success fee”.

Analysis of international experience, particularly, the USA, confirms abuses in class actions associated with “success fee”. For instance, in 2008 a case was investigated against attorneys that concluded an agreement to bribe plaintiffs in class actions and managed to gain considerable payments on settlements\(^7\).

Under the draft law, in a civil process respondent’s expenses for attorneys are not compensated even if a claim is dismissed while plaintiffs are relieved from state levy. In an arbitration process if a case is dismissed the respondent’s costs are compensated to a reasonable extent; if a case is allowed, the plaintiffs’ cost are compensated in full. This standard breaches not only the interests of a respondent but also the principle of equality before the law and Court since one of the parties is deprived of the right to compensate judicial costs regardless of the case outcome.

The opt-in model considerably reduces the above risks because it imposes additional obligations upon claimants at the stage of preparing class actions, preventing claims without evidentiary base, when the main aim is to “scare” a respondent.

In addition, the following measures can achieve the balance of interests of class action participants:

- Introduce the minimum amount of claim (for example, no less than 2 million RUB) for considering as a class action (similar to Article 227 of the Arbitration Procedural Code8) due to complexity and time-consuming case administration (for the parties as well as Arbitration Courts)
- Do not change the current law in the part of judicial costs and preserving the standard on charging the costs incurred by a party to the benefit of which a judicial act is issued (whether a plaintiff or a respondent), provided they are reasonable (Part 2 Article 110 and Article 100 of the Arbitration Procedural Code); do not introduce

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\(^1\) [http://supreme.justia.com/cases/federal/461/720/](http://supreme.justia.com/cases/federal/461/720/)
\(^7\) Establishes criteria, particularly on the claim price to consider under the simplified procedure.
an exemption from state levy in class actions in a Court of general jurisdiction.

Determine the procedures for paying “success fee” to eliminate corruption and prevent enrichment of unfair plaintiffs. As a principally new institution is being introduced to the current system of Russian law, perhaps a condition should be established that “success fee” by definition must be paid by plaintiffs without the right to charge a respondent. In clearly specified cases it might be possible claim a fee, for instance, when a fee is the only expense item (a plaintiff’s attorney incurs costs independently in the course of judicial proceedings expecting to get a compensation in the form of a “success fee”.

**DAMAGES OR RECOVERING INCOME TO THE BUDGET: AGAIN ON THE KEY POINT**

Under the Law “On Protection of Competition” an antimonopoly violator can be required to transfer to the federal budget the income gained by violating Part 1 Article 23 and Part 3 Article 51. In 2009 the Constitution Court of the Russian Federation ruled that applying two sanctions simultaneously – an administrative “turnover” fine (as a penalty) and transferring unlawful income to the federal budget (as a compensatory measure) does not contradict a “general legal principle non bis in idem”.

Recovering damages is a compensatory measure aimed at recovering losses of the injured party incurred through a violation. If the draft Law is adopted, there will be a risk of simultaneous application of two compensatory measures to a respondent for antimonopoly violations.

Removing the provisions on the right of the antimonopoly authority to recover income to the budget minimizes the risk. Antimonopoly violators can still be punished by administrative (fine), civil (recovering damages) and criminal sanctions (imprisonment).

**Res judicata**

The draft Law gives pre-judicial effect to acts of the antimonopoly authority and does not provide for the grounds to suspend class actions before appealing a decision of the antimonopoly authority. Therefore, a provision must be formalized that if a claim is filed to invalidate a decision of the antimonopoly authority, proceedings on a class action must be suspended under Clause 1 Part 1 Article 143 of the Arbitration Procedural Code (or paragraph 5 Article 215 of the Civil Procedural Code) before a Court decision comes into force on a case on invalidating a decision of the antimonopoly authority.

Improving the provisions on the institution of class actions and adding new conditions to enable its successful implementation in Russia correspond with the best international practices. In the USA and in the EU class actions protect consumer interests in many sectors of economy. At the same time, it seems that adopting the European experience better suits the existing national norms in Russia; possible risks must be carefully analyzed and legal drafting methodology of the draft Law used scrupulously.

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THE PROSPECTS OF CLASS ACTIONS IN THE RUSSIAN REALITIES
IS EVERYTHING THAT SIMPLE?

Lately, there have been active discussions on the prospects of introducing an institution of class actions in Russia, particularly in antimonopoly enforcement.

Adopting this institution in the Russian legal system is required under the Actions Plan (Road Map) for “Developing Competition and Improving the Antimonopoly Policy”, approved by the Government of the Russian Federation on 28.12.2012. The Section on “Increasing the Level of Consumer Rights Protection” provides for:

- Devising by November 2013 a draft federal law aimed at creating legal mechanisms of protecting the rights and legitimate interests of groups of persons at Courts (class actions), including participation of legal persons in class actions as well as a system of consumer protection from violations of the antimonopoly law.
- Drafting by October 2014 a federal law to formalize many-fold damages for violating the law on protection of competition and a mechanism of allocating the recovered damages to the injured persons.

It means that within two years Russia can have an institution of class actions with many-fold damages for violating the competition law.

A concept of many-fold damages obviously refers to the so-called “American” model of class actions established in the USA. Let’s outline its key elements to evaluate the consequences of introducing a similar institution in Russia:

1) The opt-out principle: establishing a group of persons in class actions in the absence of an evident wish to join the group
2) Attorney’s “success fee”
3) “Multiple damages” paid by a respondent to compensate “damages” to the members of a group of persons
4) Preferences to the claimants that lost a case in compensating the respondent’s costs (typically are not charged if a case is lost).

The “American” model did not spread in the European Union. In the opinion of the European Commission, a combination of such factors as imposing a fine on top of recovery of damages, possibility to bring actions in defense of an unlimited number of injured persons, attorneys’ “success fee”, and large-scale discovery procedures increases the risk of abuse of right to an extent incompatible with the European legal traditions.

Thus, the main reason why the “American” model of class actions is not used in other countries is that it can be conducive to the legal conditions that provoke unjustified claims and encourage groups of interested persons to seek benefits without truly protecting consumers.

Let’s analyze possible economic and other consequences that can be predicted for participants of Russian markets and Russian economy in general in case of adopting the American experience.

The key reason why is it unacceptable to copy the “American” model, in the authors opinion, is the number of cases initiated by the antimonopoly bodies in the Russian Federation (thousands per year in comparison with the minimum level in Europe and in the USA).

According to FAS statistics, in 2012 the antimonopoly bodies initiated over 9800 cases for violating the competition law (plus over 5500 cases for violating
Class actions will apply to all violations of the antimonopoly law so “public” subjects that commit one third of the violations revealed by the antimonopoly bodies can also be respondents in class actions with multiple damages. For instance, in 2012 FAS identified 3165 facts of competition-restricting acts and actions (omissions) that had signs of violating Article 15 of the Federal Law “On Protection of Competition”, by federal executive bodies, the authorities of the subjects of the Russian Federation, local self-government bodies and other subjects6. Since these subjects are financed from budgetary resources, damages in class actions will also be recovered from the budgets of different levels.

In view of the above, introducing class actions with multiple damages in Russia can throw into question the efficiency of these measures in terms of consumer protection and can hamper development of competition, contradicting the goals of antimonopoly regulation (Article 1 of the Federal Law “On Protection of Competition”)

Considering the established antimonopoly enforcement practice and the importance of a balanced approach, that takes into account all possible consequences of a new initiative, a Russian model of class actions should be based on the following key principles:

1) Establishing a group of persons on the basis of evident expression of will by a person through filing a petition for joining an action
2) Recovering actual, rather than multiple damages which accords with the fundamental principle of Russian civil law – restore the violated right
3) No additional preferences to the claimants, whose claims were dismissed, for covering judicial expenses, particular, the costs incurred by the respondent to the case for a legal representative
4) No attorney’s “success fee” in class actions.

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3 Further on referred to as the Register.
5 In 2012 the antimonopoly bodies issued 6657 determinations on imposing administrative fines for antimonopoly violations: in total over 11.6 billion RUB, the most part of this sum were “turnover” fines. See: http://fas.gov.ru/about/list-of-reports/list-of-reports_30077.html.
6 See: http://fas.gov.ru/about/list-of-reports/list-of-reports_30077.html.
SO DIFFERENT DEPOSITS OR RULES OF COMPETITIVE STRUGGLE

Today, the main competitive struggle among banks is aimed at attracting and forming a deposit base. In the fight for good clients and “new” monies, banks are forced to adjust to market developments as quick as possible, by offering attractive banking products to consumers.

The bank to win this competitive struggle will be the one that constantly expands the range of its services, reduces their cost, improves the quality of credit, settlement and cash services, provides certain benefits when granting loans, offers advice of various kind to the clients, etc. This is a rule of fair competition.

Nevertheless, it is not surprising that sometimes under such tough conditions the temptation to surpass competitors makes the players use ungentlemanly and unfair ways to compete, which, despite their effectiveness, often involve quite significant risks, including antitrust risks.

Using the example of a recent antitrust case, we will try to highlight what should be taken into consideration while implementing such banking product as a deposit and at the same time how to avoid drawing the attention of the antitrust authorities.

A bit of theory
In accordance with Article 14 of Federal Law No.135-FZ “On protection of competition” dated 26.07.2006 (the “Competition Law”), one of the forms of unfair competition is misrepresentation of the nature, method and place of production, consumer properties, quality and quantity of goods or their manufacturers.

When reading literally this provision of the Competition Law, it is clear that in order to qualify an action as an act of unfair competition what needs to be determined is the fact of any person providing misleading information about itself and/or its products or committing other misleading actions.

That provided, such action must:

■ be aimed at receiving benefits in the course of business activity;
■ contradict laws of the Russian Federation, good business practices, requirements of good faith, reason and fairness;
■ cause damages to other competing businesses or to their goodwill.

Actions corresponding to the above criteria are qualified as unfair competition in any field of business and on any goods market. And the banking services market is no exception.

The Russian Federal Antitrust Service (FAS) has in the past qualified as an act of unfair competition the actions of banks aimed at attracting monies in deposits with the consumer properties of such deposits subsequently degrading.

Example from practice of an antitrust authority
An example would be the case on breach of antitrust law examined by the Russian Federal Antitrust Service in relation to Uniastrum Bank.

As follows from the decision of the antitrust authority, in the period from December 2008 to December 2009 Uniastrum Bank entered into agreements for fixed-term deposits. Under the terms and conditions of these agreements, the only condition for withdrawing monies from the fixed-term deposit accounts was a transfer of such monies to current accounts opened at Uniastrum Bank. However, in 2010 Uniastrum Bank introduced a 7% commission for withdrawing money from the current accounts, which was deposited to such accounts from fixed-term deposit accounts.

Thus, in effect Uniastrum Bank introduced a commission for withdrawing money from fixed-term deposit accounts and in such way unilaterally changed the terms and conditions of the agreements for fixed-term deposits.

It should be noted that undoubtedly the opportunity to withdraw money from fixed-term deposit accounts without any additional commission is an important condition for clients when choosing a credit organization, and for the bank this is a decisive advantage over similar banking products offered by competitors.

The commission introduced by Uniastrum Bank for withdrawing money resulted in clients losing the opportunity to receive income from their deposits which was promised to them at the time of entering into agreements. Consequently, the consumer properties of such deposits under agreements already
executed have essentially worsened compared to the properties declared initially.

Thus, Uniastrum Bank has mislead its clients in relation to the consumer properties of their deposits at the time of entering into relevant agreements.

Also, the FAS emphasized that the commission introduced by Uniastrum Bank for withdrawing money could result in losses incurred by competitors in the amount of profit not received from deposits of individuals which such organizations would be able to receive if the clients of Uniastrum Bank were, at the time of entering into an agreement, informed of the commission to be introduced afterwards for withdrawing money.

According to the antitrust authority, such practice contradicts both the applicable legislation because Article 310 of the Russian Civil Code prohibits unilateral refusal to fulfill an obligation in connection with business activity conducted by the parties and requirements of good faith, reason and fairness.

Thus, the actions of Uniastrum Bank described above contain all traits of unfair competition.

Having examined this case, the Committee of the FAS held Uniastrum Bank liable for violating Part 1 Article 14 of the Competition Law as pertains to actions aimed at attracting monies of individuals into deposits with consumer properties subsequently degrading compared to the properties declared initially due to the commission introduced for withdrawing from current accounts money which was deposited into such accounts from fixed-term deposit accounts.1

Furthermore, Uniastrum Bank was ordered, among other things, to return to individual clients the money retained as commission.

**Position of courts**

The decision and order adopted by the antitrust authority after examination of this case were disputed by Uniastrum Bank in a legal procedure. Nevertheless, the courts fully supported the position of the FAS as pertains to justification of Uniastrum Bank's actions being acknowledged an act of unfair competition.2

In particular, the courts came to the conclusion that such actions committed by Uniastrum Bank resulted inter alia in the bank's unilateral refusal to fulfill its obligations under the agreements, i.e. the obligation on returning in full the amount of the deposits and interest accrued thereon as set forth in such agreements and Part 1 Article 834 of the Civil Code, and standard contracts of Uniastrum Bank do not contain any references to the bank's right to unilaterally change conditions of the agreements.

Also, the courts confirmed the conclusions made by the antitrust authority as regards possible losses incurred by competitors due to actions of Uniastrum Bank and as regards such actions contradicting requirements of good faith, reason and fairness.

It should be noted that this case is not the only case considered by the antitrust authority in respect of credit organizations on similar grounds. In all cases, the courts supported the position of the FAS.

This evidences both the developed court practice on this matter and justified position of the antitrust authority.

**Value of the case**

Undoubtedly, the ultimate purpose for any commercial bank implementing a deposit policy is to increase its resource base and at the same time to minimize expenses.

However, when developing its deposit policy, a bank should understand that the main issue is not the availability of such deposit policy, but its quality and compliance with requirements of the law, including antitrust law.

In view of the case described in this article, we believe that in order to exclude antitrust risks a bank should have a clear idea of not only how to attract new clients, but also how to fulfill all the declared terms and conditions of the relevant agreements in the future. The consumer must be informed of all the essential terms of a financial product, and the information on consumer properties of a service must be accurate. To implement this, the bank must have a clear, well established control system, including control over how a particular banking product is offered, advertised and sold.

And of course one should always bear in mind that fooling clients can always result in a credit organization being subject to essential economic and reputational risks since the deposits can be so different...

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2 Decision of the Commercial Arbitration Court of Moscow and Decree of the Ninth Commercial Arbitration Appeal Court on case No. A40-39832/12.