**Federal Trade Commission**

# NYSBA International Law and Practice Section
**October 20, 2006**
**Shanghai, China**

# Adoption of Trade Regulations in China, Scope and Effect: An American's View

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I am delighted to meet with you here in Shanghai and to provide some thoughts on the development of China's draft Anti-Monopoly Law. My remarks today reflect my personal views and not necessarily those of the Federal Trade Commission, any of its other Commissioners, or the government of the United States.

The draft Antimonopoly Law represents a ten-year effort to formulate a comprehensive competition law that is expected to bring some cohesion to the existing Chinese competition law regime. I appreciate the resources that the Chinese government has devoted to crafting a competition law that has the potential to contribute to the growth of the Chinese economy and the welfare of its people. The transparency of the drafting process and the willingness of the Chinese government to seek advice from foreign competition officials and experts are especially commendable. U.S.

government officials, including those from my agency and the Department of Justice, have been active for years in providing advice to government officials in many countries that were drafting competition laws, some for the first time. Official from my agency, the Federal Trade Commission ("FTC" or "Commission"), and our Department of Justice ("DoJ") have attended numerous meetings and seminars over the past few years. They have commented on approaches and issues under consideration in drafting the new Chinese law and have shared their views of sound competition law principles and best practices, based on the United States' long experience with antitrust enforcement.

These comments have emphasized certain key principles of U.S. antitrust law: protecting the competitive process rather than individual competitors; focusing on effects on consumer welfare rather than on producer welfare; using competition law to promote competition rather than other social and economic objectives; promoting efficiency even if some competitors do not survive; treating all firms equally without regard to nationality; and protecting legitimate intellectual property rights. They have stressed that a competition law grounded in sound legal and economic principles is an important element of a dynamic, well-functioning economy, and that economic growth and consumer welfare benefit from robust competitive domestic markets.

China faces a particular challenge in making the transition to a market economy from a long-standing, centrally-planned economy with a large state sector. I strongly endorse the provisions of the draft law that could be used to prohibit public restraints on competition imposed by government entities or pursuant to government regulation. Without such authority, the new competition agency may not be able effectively to address a major, durable source of anticompetitive conduct that could harm the Chinese economy and consumers. Government enterprises should be subject to the competition law. Exempting them from competition law coverage solely because of their status as government owned or controlled enterprises would likely harm both competition and consumers.

Although successive drafts of the Anti-Monopoly Law that the Chinese government has shared with us indicate that the drafters have benefitted from external advice, there are still provisions that would benefit from further modification. Today, I would like to focus my remarks initially on some important substantive concerns, particularly those relating to abuse of dominant position, premerger notification thresholds, exemptions, and the relationship between intellectual property rights and the Anti-Monopoly Law. In doing so, I will point out differences in approach between the draft Anti-Monopoly Law and U.S. antitrust law and international law and practice. I will then discuss the relationship between U.S. competition laws and intellectual property rights in the standard-setting process.

## I. Abuse of Dominant Market Position

United States law does not specifically address "abuse of dominant market position." Section 2 of the Sherman Act prohibits the closely related concept of monopolization. The essential elements of the offense of monopolization are (1) the possession of monopoly power in a relevant market, **and** (2) the use of exclusionary conduct to acquire, preserve or expand monopoly power, as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.[1]

The treatment of unilateral conduct by monopolists or firms with dominant positions is the most challenging area of competition policy, because it is the area where it can be difficult to distinguish between beneficial hard-nosed competition and harmful exclusionary conduct.

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1 United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966).

Competitive conduct frequently looks like exclusionary conduct, because aggressive competition may harm less efficient firms. These less efficient firms may in turn complain to competition authorities to seek government protection from legitimate competitive pressures. But the goal of competition law should be the protection of the competitive process rather than individual firms. U.S. law does not protect less efficient firms from legitimate, vigorous competition from another firm, even if that firm holds a dominant or monopoly position. Determining whether a competitor is competing aggressively or acting anticompetitively is a challenge that is best met by the application of objective, economically-based, and transparent standards.

We want businesses - all businesses, including firms with dominant positions - to compete vigorously, day in and day out. We want them to continue to invest in research and development that may generate new or enhanced products and services. In the long run, these practices tend to foster innovation and promote economic growth and well-being. But if some firms perceive that their routine, day-to-day decisions are being second-guessed by enforcers -- just because their companies may hold a dominant position -- we should not be surprised to see them competing less vigorously, or taking fewer R&D risks. As a result, competition may be suppressed, not enhanced, by treating dominant firm conduct as automatically suspect.

**Determination of Dominant Market Position**

The draft Anti-Monopoly Law presumes a dominant market position based on the market share of a single firm or the combined market shares of two or three firms. Without further analysis, such presumptions can yield an erroneous conclusion because high market share by itself is not inevitably a reliable indicator that a firm has market power in any particular market. Under the laws of the United States and many other jurisdictions, market shares are only the starting point for detailed economic analysis of factors relevant to an assessment of a firm's market power.

Under U.S. antitrust law, durable market power is the ability to profitably maintain price over competitive levels for a significant period of time. In making this determination, we first define the relevant product and geographic market and then determine the firm's market share in the relevant market. We then carefully analyze the structure and competitive dynamics of the relevant market, examining the presence or absence of barriers to entry, such as government limitations on new entrants or proprietary technology that is unavailable to potential competitors. Other relevant factors include the pace and nature of technological change and innovation in the relevant market, market trends, such as whether the market is expanding or contracting, the existence of excess capacity that can be used to increase output in the event of a price increase, and key customers whose size or attributes create an ability to resist a price increase. An analysis of these factors is essential to determining the significance of market shares in the evaluation of market power. I note that several of these factors are listed elsewhere in the draft Anti-Monopoly Law's provisions on abuse of a market dominant position.

The very nature of U. S. antitrust analysis, therefore, argues against using conclusive presumptions of dominant market position based on market shares alone. Market share presumptions for establishing joint dominance are even less appropriate. Aggregation of market shares of competitors to find joint dominance makes little legal or economic sense absent some agreement among those firms to exercise their market power jointly. Further, if there is such an agreement, the better approach is to address it under provisions prohibiting anticompetitive agreements among competitors.

Accordingly, the legal standards for market dominance should clearly indicate that the determination is based on the establishment of durable market power – the ability to maintain price over competitive levels for a significant period of time – which will be based on an economic analysis of the range of factors generally considered in analyzing market power. Alternatively, if some presumptions based on market shares are deemed necessary, they should be rebuttable presumptions. A rebuttable presumption provides an opportunity for a firm to offer proof either that it does not possess market power or that any market power it does possess is not durable.

Before leaving this topic, I should add that it may be appropriate and helpful to the business community for the Anti-Monopoly Law or implementing regulations to establish a safe harbor. That is, a market share below which there will not be a finding of a market dominant position. In the United States, we do not bring enforcement actions challenging unlawful monopolization where the market share of a firm is less than 50% because a firm with a market share below this level is unlikely to have durable market power.

**Prohibited Conduct**

The draft Anti-Monopoly Law prohibits a firm with a dominant market position from engaging in certain specified conduct. Each example of abusive conduct is a type of conduct that will usually constitute legitimate competitive behavior. Some of the prohibited conduct can be anticompetitive under particular circumstances. These provisions of the draft Anti-Monopoly Law are deficient because they fail to distinguish clearly legitimate competitive conduct from that which injures competition. Without careful economic analysis of competitive effects, these prohibitions pose a significant risk of interfering with procompetitive conduct by, for instance, undermining a firm's ability or willingness to provide product innovations or to adopt more efficient production or distribution methods.

An example of prohibited conduct in the draft law that raises these concerns is the prohibition of "unfair" high pricing. U.S. competition law does not limit the price that a monopolist is permitted to charge – a monopolist may charge as high a price as the market will tolerate. Risky investments in innovation are often undertaken only because of the prospect of receiving a large return from a major technological breakthrough or a popular new consumer product. As our Supreme Court has observed:

> The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices – at least for a short period – is what attracts "business acumen" in the first place; it induces risk taking that produces innovation and economic growth.[2]

Unless the monopolist sells its product in a market characterized by barriers to entry, high prices normally will attract firms to enter the market – especially when the new entrant can offer a lower price, a better product, or enhanced services. New entry can restore the competitive equilibrium, tending to drive prices back toward competitive levels without the need for government intervention. Allowing market forces to work rather than resorting to enforcement to control supra-competitive prices avoids burdening competition officials with the difficult and unnecessary task of monitoring prices and evaluating whether they are "unfair" or "excessive." In the United States, the FTC or DoJ are not asked to set "fair" prices because it is beyond the agencies' core competence and a diversion of their limited enforcement resources.

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[2] Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 407 (2004).

The draft law also prohibits selling below cost without valid reasons. U.S. competition agencies and courts are particularly cautious when evaluating claims that predatory or low pricing is likely to lead to the acquisition or maintenance of a monopoly. Aggressive price-cutting looks precisely the same as legitimate competition. Mistakes regarding predatory pricing can be very costly – prohibiting price reductions deprives consumers of the very benefits competition laws are intended to promote. Therefore, U.S. competition law treats predatory pricing as illegal only in the unique and unlikely situation where a firm can reduce its prices below cost long enough to drive the competition out of the market and then raise prices high enough for a sufficiently long time to recoup the lost profits from the earlier below-cost sales.[3] If the firm cannot recoup its losses, the below-cost sales are unlikely to injure competition.

To avoid discouraging legitimate, aggressive discounting, the draft law or implementing regulations should specify the circumstances in which a violation will be found. That is: the prices must be below an appropriate measure of cost; and the firm must be likely to recoup its losses in the future.

There are other examples of abusive conduct covered in the draft law which require carefully focused analysis. Refusals to trade, exclusive dealing, tying and price discrimination may, in any given case, be either beneficial or harmful to competition. Such conduct or agreements can be competitively neutral or procompetitive, especially when they align the interests of manufacturers and distributors, encourage better service, or otherwise stimulate competition. Conversely, these same practices in other circumstances can be misused to restrict or limit competition unreasonably.

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[3] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 222-224 (1993).

Distinguishing the good from the bad invariably requires careful, indeed, usually rigorous, analysis of actual or likely market effects. To that end, U.S. competition authorities apply a "rule of reason" analysis, assessing the procompetitive and anticompetitive effects to determine if any conduct or agreement unreasonably and substantially limits competition before initiating enforcement actions in these areas. The draft law or implementing regulations should clearly state that these types of conduct and agreements are prohibited only where they (1) have no reasonable or legitimate business justification and (2) exclude or substantially limit competition so as to create, strengthen or maintain a dominant market position.

## II. Notification Thresholds for Concentrations

The proliferation of competition laws that include premerger notification requirements and an increase in transnational merger and acquisition transactions has resulted in the more frequent occurrence of multiple reviews of the same transaction by the competition authorities of several nations. Requiring notification of mergers that do not meet an appropriate standard of materiality as to the level of "local nexus" imposes unnecessary transaction costs and delays and diverts scarce resources of reviewing competition authorities from more important enforcement priorities without any corresponding enforcement benefit. Recognizing this, the International Competition Network ("ICN"), a network of 99 competition agencies devoted to promoting convergence on sound competition principles, developed a set of Recommended Practices for Merger Notification Procedures that represents international consensus on principles and best practices for premerger notification systems.[4]

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[4] The Recommended Practices are available on the Internet at: http://www.interntionalcompetitonnetwork.org/notification.html.

The ICN's Recommended Practices provide that each jurisdiction's merger review rules should seek to screen out transactions that do not have an appreciable effect on competition within the jurisdiction. Notification of a transaction should not be required unless the transaction is likely to have a significant, direct, and immediate economic effect in the jurisdiction concerned. The ICN recommends that notification thresholds require that at least two parties to a transaction have significant local activities or that if local nexus requirements are based on a single party's domestic contacts, the thresholds should focus on the local activities of the acquired business and use thresholds that are sufficiently high to avoid notification of transactions without potential material effect on the local economy. The ICN Recommended Practices specifically state that the most suitable thresholds are based on significant local sales or asset levels within the jurisdiction.

U. S. premerger notification thresholds provide that the parties must have combined U.S. sales or assets exceeding $113.4 million and the acquired party must have assets or sales in or into the U.S. exceeding $56.7 million. In addition, the U.S. ensures that foreign transactions have an adequate nexus with the U.S. by exempting certain foreign transactions from notification obligations. For example, the U.S. exempts acquisitions of foreign assets where those assets generate less than about $57 million in annual sales in the U.S., and acquisitions of stock in a foreign company when the acquired company has less than about $57 million in assets in the U.S. or less than $57 million of annual sales in or into the U.S. These thresholds are adjusted annually based on changes in the Gross National Product of the United States.

The premerger notification thresholds in the draft Anti-Monopoly Law appear to be inconsistent with the ICN Recommended Practice concerning local nexus to the reviewing jurisdiction because they would require reporting of merger and other transactions that do not have an appreciable effect on competition within China. The inconsistency stems from the notification requirement in the draft law that is based on one of the parties having a certain level of total turnover in China. Notification then would be required even if only the acquiring firm's total turnover in China meets or exceeds the prescribed level. The ICN Recommended Practices specifically discourage notification thresholds that can be satisfied based solely on the acquiring firm's local activities, irrespective of any local activity by the firm to be acquired because of the unnecessary transactional burdens and lack of any significant effect on the local economy.

## III. Exemptions

I will now turn to the provisions of the draft Anti-Monopoly Law relating to exemptions. All countries have some exemptions from the coverage of their competition laws. The key is keeping the exemptions as narrow and as clear as possible. This will help reduce uncertainty as to the basic goals of the competition law and facilitate its enforcement.

The U.S. competition authorities do not have the power to grant an exemption from our antitrust laws. Exemptions to U.S. laws have been created largely by statutes enacted by Congress, and sometimes by our courts. If Congress decides that other policy considerations should take priority over our antitrust laws, it enacts specific legislation for that purpose. We do not believe that it is in the best interest of our economy for competition officials to try to balance competition policy with other objectives, such as industrial policy, economic development, or employment, in making their enforcement decisions. Factors other than competition do not readily lend themselves to objective economic analysis and tend to undermine the predictability and consistency of a competition agency's enforcement decisions. Further, limiting a competition agency's evaluation to competition issues enables the agency to focus on its core area of expertise, promotes public confidence in the economic basis of competition law, and avoids confusion.

The draft law should clarify that only conduct that is specifically authorized by law will be exempt. The draft law currently authorizes the competition authority to grant specific exemptions for monopoly agreements and lists specific factors to be considered in making the decision. Any exemption decision by the agency should be based solely on competition factors. In addition, the draft should make clear, as it does with bid-rigging, that hard-core cartel conduct, such as price-fixing or market division among competitors, will not qualify for exemption.

## IV. The Interface of Intellectual Property Rights and Competition Law

I would now like to turn to the provision in the draft Anti-Monopoly Law relating to intellectual property rights. The draft law would apply only to conduct that abuses intellectual property rights and restricts and eliminates competition. We support this narrow application of the draft law to intellectual property rights. However, the law is silent about the relationship, if any, of this provision with other provisions of the draft law, such as those on abuse of dominant market position. We remain very interested in the manner in which the Anti-Monopoly Law will ultimately be implemented with respect to intellectual property rights. Both intellectual property rights – specifically patents – and competition play an important, complementary role in promoting innovation, economic growth and consumer welfare. Achieving the proper balance between competition law and intellectual property rights is critical to facilitating, rather than impeding, innovation. This issue of the proper balance is particularly important at this juncture for the Chinese economy. It is timely and appropriate, therefore, for me to focus my remaining remarks on the topic of intellectual property rights, and more specifically on two aspects of them: how they affect standard setting; and how these rights fit in with the overall competition enforcement policy.

Regarding the latter, economists have long known that innovation is a principal factor in fostering a dynamic, growing economy. Innovation promotes consumer welfare and economic efficiency in a number of ways. It drives down costs through the development of more efficient production and distribution techniques. It stimulates economic growth by bringing desirable new products into the market. It also may limit the creation and exercise of market power by fostering the development of new technologies that permit entrants to leapfrog the advantages of and the entry barriers enjoyed by entrenched dominant firms. One of the cornerstones of innovation is intellectual property, because it is both a key input into and a byproduct of successful innovation. Intellectual property, therefore, is a highly valued asset in every economy, and it has been granted substantial legal protection by most nations of the world, including the United States, in order to preserve that value.

Additionally, there is a close relationship between intellectual property rights and standard setting, and both are affected by competition policy. A sound evaluation of their interrelationship requires that business, economic, and legal principles be considered in combination in order to maximize economic progress and the economic welfare of our citizens. Properly understood and applied, intellectual property rights and antitrust law are complementary, not conflicting, legal systems that should be employed harmoniously to promote a vibrant, healthy economy. Both systems can, and should, be applied to standard setting activities in such a manner as to maximize innovation and consumer welfare.

**Scope of Protection for Intellectual Property Rights**

Given the importance of intellectual property in fostering economic progress, one might wonder whether the world's economies might progress even faster if intellectual property were more freely available for others to use and build upon – *i.e.,* treated more like a public good than private property. While that idea has some simple appeal, an erosion of intellectual property rights would be extremely shortsighted. There is an international consensus today that a strong intellectual property regime is needed to provide an incentive to undertake costly and risky investment in innovative activities.

It can be very expensive to conduct the research and development that is necessary to come up with new products and technologies. It is quite common for there to be many failures before a successful innovation is achieved. There would be little incentive for firms to make such a risky investment in research and development if others could freely copy or use a successful innovation and prevent the inventor from realizing well-earned rewards. Effective intellectual property rights are one of the most important means for providing those incentives. In the United States, intellectual property rights laws give innovators the right to exclude others from using their inventions for a specified period, and thus guarantee the innovators an opportunity to realize a return commensurate with the value of the invention and the risk that was undertaken. Protecting intellectual property rights is one of the major challenges – and obligations – of a global economy.

Certain elements are necessary in any intellectual property system in order to provide meaningful protection to the holders of those rights. Consider an inventor who holds a valid patent that covers a particular invention. Three propositions regarding the rights of the inventor merit emphasis.

First, the inventor has a legal right to exclude others from using that invention for an appropriate period of time. As a necessary corollary, antitrust liability for unilateral, unconditional refusals to license patents should not play a meaningful role in the interface between IP rights and antitrust protections.

Second, whether the inventor chooses to commercialize the invention or license it to others, the inventor may unilaterally set the price or license fee at whatever level it chooses. Indeed, the prospect of potentially high profit is a major incentive for undertaking risky and costly innovative endeavors, and the entire thrust of the intellectual property laws is to use that incentive to encourage innovation. The United States Supreme Court recently noted that the opportunity to charge high prices "induces risk taking that produces innovation and economic growth."[5] Accordingly, there is no violation under U.S. antitrust law for unilaterally pricing an IP license "too high."

Third, there should not be a presumption that a patent or other form of intellectual property by itself creates market power. Although a patent creates an exclusive right to the invention, there may be substitutes that can accomplish the same function as the invention. Therefore, a careful market analysis is needed to determine the scope of the relevant market and whether the patented invention has market power. The FTC and the Department of Justice, in their joint *Intellectual Property Guidelines*,[6] have long held that IP rights cannot be presumed to create market power. The U.S. Supreme Court unanimously endorsed this position earlier this year.[7]

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[5] *Trinko,* 540 U.S. at 407.

[6] U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property* § 2.2 (Apr. 6, 1995), *available at* http://www.ftc.gov/bc/0558.pdf.

[7] *Illinois Tool Works*, *Inc. v. Independent Ink, Inc.,*126 S. Ct. 1281 (2006).

There can be situations where intellectual property rights will confer market power, as when a patented invention dominates a relevant market. That outcome, without more, does not violate American IP or antitrust law. Indeed, the possibility of such an outcome is a major incentive to engage in innovative activities, and the IP laws use that incentive to encourage innovation. A violation of U.S. antitrust law requires an element of anticompetitive conduct – *i.e.,* conduct that is not competition on the merits or efficiency-enhancing, that tends to exclude competitors or potential competitors from the market, and enables the intellectual property rights holder to create, maintain, or extend its market power.

Of course, so far I have been discussing unilateral conduct by an intellectual property rights holder. Joint conduct, particularly with a competitor, raises the possibility of anticompetitive collusion or exclusion, and must be examined with those possibilities in mind. Even so, U.S. antitrust law recognizes that many forms of collaborative conduct can be efficiency-enhancing, and so most forms of collaboration are analyzed under a standard – known as the rule of reason – that balances potential anticompetitive losses against procompetitive gains. One of the most important areas in which collaborative conduct can promote competition involves joint efforts to set standards.

**<u>Intellectual Property Rights and Standard Setting</u>**

Intellectual property rights increasingly are implicated in standard setting and licensing arrangements. For example, standards that enable the interoperability of products or services, such as the telecommunications network or a mobile phone system, may incorporate multiple technologies protected by intellectual property rights, often held by more than one person or entity. The licensing of intellectual property rights may substantially influence the way in which new technologies are disseminated and, in turn, affect the introduction of new products and services in the marketplace.

Intellectual property rights licensing arrangements frequently are associated with the introduction of standards. In short, standard setting and IP licensing policies may greatly affect the development of new goods and services, future innovation, and the competitiveness of markets.

Standard setting is increasingly important as a way of reducing transaction costs, and standards have a particularly important role in ensuring compatibility and interconnectivity of products and services. Standards may be particularly important in markets with "network effects" (where the utility of the network rises as parties are added to it) and complex technologies such as information technology and telecommunications. The technological revolution that we are experiencing in these markets has benefitted from, and resulted in, significant standard setting activity.[8] Standards may prove important in "low tech" industry settings as well, and in global trade.

**<u>The Standard Setting Process: Key Characteristics</u>**

Standards can be defined succinctly as "any set of technical specifications that either provides or is intended to provide a common design for a product or process."[9] As economies become more complex, the need for standards grows. They affect almost every aspect of our lives, from the food we eat, our health care, the vehicles we travel in, our information technology systems, and numerous

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[8] *See* Janice M. Mueller, SYMPOSIUM: PATENT SYSTEM REFORM: *Patent Misuse Through the Capture of Industry Standards*, 17 Berkeley Tech. L.J. 623, 631-32 (2003); Marc Hansen *et al*, *Disclosure and Negotiation of Licensing Terms Prior to Adoption of Industry Standards: Preventing another Patent Ambush*?, Eur. Competition L. Rev. (Dec. 2003); Robert A. Skitol, *Concerted Buying Power: Its Potential for Addressing the Patent Holdup Problem in Standard Settin*g, 72 Antitrust L. J. No. 2, 727, 730 (2005) (explaining that the patent holdup problem "arises from the interaction of (1) proliferating patents generally and (2) proliferating needs for standards to enable interoperability among both competing and complementary products seeking to exploit new technologies").

[9] Mark A. Lemley*, Intellectual Property Rights and Standard Setting Organizations*, 90 Cal. L. Rev. 1889, 1896 (2002).

aspects of our entertainment. They are promulgated by governments,[10] by private groups, or arise from their spontaneous acceptance by the marketplace.

In the United States, standard setting is largely done by private entities. This private standard setting process enhances competition in most instances. It offers the greatest likelihood that an efficient standard will emerge – perhaps through consensus standard setting, or through competition between standards, or through some combination of both processes. A market economy is based on the premise that competition is more likely than other forms of economic organization to maximize economic progress and produce the optimal outcome for consumers with respect to product price, quality, and innovation. That premise should be valid regardless of the degree of standardization that is appropriate in an industry. Consensus acceptance of a standard within a market indicates that there is more than one way of providing an element of a product or service that consumers want, but the market would be better served by use of a common method. That does not mean that competition in the technology that is being standardized is no longer important. At the standard setting stage there is competition among alternative technologies to be included in the standard. There is no reason that competition to be included in a standard should be any less market driven than competition in the downstream market for products or services that incorporate the standard. Given the basic premise of a market economy, we can expect market participants in a competitive system to select the technology that is most likely to meet consumer needs and desires in an efficient manner. After a standard is established, however, competition for that standard does not end. There

[10] Governments may develop their own standards or endorse and adopt private standards through the passage of laws or regulations.

always will be competition to improve upon the standard and, perhaps, to supersede it. Here again, the preference of the market is an excellent arbiter of which technology prevails.

**Antitrust Implications of Standard Setting**

Standard setting normally is an efficiency-enhancing activity and, as such, usually does not raise significant antitrust concerns. On the contrary, standard setting usually is considered to be procompetitive. However, under exceptional circumstances, antitrust concerns can and do arise. The standard setting process may raise such concerns if it involves unreasonably exclusionary conduct or anticompetitive collusion. For example, in one American case,[11] makers of steel conduit were found liable for "packing" an SSO meeting with its agents and thereby improperly obtaining an SSO decision that limited the standard to steel conduit, thereby excluding a perfectly viable alternative product (plastic conduit) from being used in the building industry. This is an example of an artificial restraint on entry, resulting in unreasonable exclusion from the market.

There are also examples of unilateral exclusionary conduct in the standard setting context. In particular, an intellectual property rights holder that takes part in standards setting may have an incentive to improperly obtain or increase the market power of its IP rights. Such a strategy may involve the IP holder: misleading a standards-setting body regarding its IP interests, leading to the adoption of a standard that "reads on" the holder's IP, and then subsequently exercising that new market power by demanding unexpected licensing royalties after a standard has been set and producers have incurred costs that "lock them in" to the standard. The FTC recently brought two cases involving that sort of conduct, one involving a governmentally-set standard and another involving private standard setting.

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[11] *Allied Tube & Conduit Corp. v. Indian Head*, 486 U.S. 492 (1988).

The FTC charged that the Union Oil Company of California ("Unocal") misrepresented to a California state environmental regulator that certain information was non-proprietary, in connection with the regulator's promulgation of a regulatory "clean air" standard for refining reformulated gasoline.[12] The regulator allegedly relied on those misrepresentations in promulgating the standard, and refiners expended billions of dollars to "lock themselves in" to the standard. After lock-in, Unocal began enforcing its patent rights against refiners producing gasoline according to the standard, thereby allegedly imposing more than $500 million of additional costs each year on California consumers. The case was settled with a consent agreement under which Unocal agreed to stop enforcing the relevant reformulated gasoline patents, and to release all relevant gasoline patents to the public, potentially saving consumers billions of dollars.

In the private SSO case, the FTC charged a computer technology firm, Rambus, Inc., with deceptive and misleading conduct in connection with a private standard setting process for technologies used in the computer memory chips found in a wide variety of products. The Commission found that the private SSO unwittingly adopted standards encumbered with Rambus's patents. Rambus sought to enforce its patents worldwide against companies manufacturing memory products in compliance with the standards. The Commission found that, through its course of deceptive conduct, Rambus was able to distort a critical standard setting process and engage in an anticompetitive hold up of the computer memory industry, and that this conduct constituted

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[12] *See* FTC Press Release, *Dual Consent Orders Resolve Competitive Concerns About Chevron's $18 Billion Purchase of Unocal, FTC's 2003 Complaint Against Unocal* (June 10, 2005), *available at* http://www.ftc.gov/opa/2005/06/chevronunocal.htm. *See also In the Matter of Union Oil Company of California*, Docket No. 9305 (June 10, 2005) (Agreement Containing Consent Order), *available at* http://www.ftc.gov/os/adjpro/d9305/050610agreement9305.pdf.

exclusionary conduct under Section 2 of the Sherman Act. The Commission reserved judgment on the issue of remedy and ordered further briefing on that issue.[13]

Neither the *Unocal* nor the *Rambus* case found liability based on the mere acquisition of market power. It is the acquisition of market power through anticompetitive conduct that is condemned by the U.S. antitrust laws, and such condemnation is entirely consistent with the effective protection of intellectual property rights.

**Respecting Intellectual Property Rights in the Standard Setting Context**

It is readily apparent that there is much at stake in how intellectual property rights are treated in a standard setting context. An intellectual property rights holder has a legitimate expectation of being rewarded for a successful innovation that is knowingly incorporated into a standard. The use of proprietary IP in the standard can substantially increase the value of that IP and may increase the cost of using that standard. Thus, an intellectual property rights holder may have an incentive to improperly use the standard setting process to obtain or increase the market power of its IP.

The danger of competitive abuse of intellectual property rights during a standard setting process does not mean it would be acceptable to override IP rights in the interest of dispersing more broadly the benefits of a standardized technology. Regardless of what short-term benefits may accrue for customers in the affected markets, there would be serious longer-term costs. As I noted earlier, IP rights provide a critically important incentive to invest in costly and risky research and development. Failing to provide adequate protection for IP rights could result in significantly less incentive to make investments in research and development, the pace of innovation could be

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13 *Rambus, Inc.*, Dkt. No. 9302 (Aug. 2, 2006) (Commission decision), *available at* http://www.ftc.gov/os/adjpro/d9302/060802commissionopinion.pdf.

reduced, and the rate of economic progress could well slacken. The derogation of IP rights by standards organizations also could make IP owners more reluctant to participate in standard setting. We would thus lose some of the benefits of standardization, and the standards adopted likely would be less efficient. Finally, weakening of IP rights are likely to have a negative impact on technology transfers and foreign investment.

This issue arises in the context of compulsory or mandatory royalty-free licensing of intellectual property rights, particularly patents. Compulsory licensing has been advocated by some Chinese officials. Under U.S. law, a firm's unilateral and unconditional refusal to license its intellectual property, standing alone, has not been an antitrust violation. U.S. antitrust officials from both the DoJ and the FTC have commented on the lack of antitrust liability for the refusal to license intellectual property.[14] Having found that an antitrust violation has occurred, however, the U.S. antitrust agencies may invoke compulsory licensing as a means of remedying the anticompetitive harm flowing from the violation. The most important criticism of compulsory licensing is that such requirements would be tantamount to requiring the IP owner to create competition in its own

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[14] Makan Delrahim, Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice, Forcing Firms to Share the Sandbox: Compulsory Licensing of Intellectual Property Rights and Antitrust, Remarks before the British Institute of International and Comparative Law, London, England (May 10, 2004) (unilateral refusal to license does not support a finding of antitrust violation, but compulsory licensing may be used in exceptional cases in the remedial phase), *available at* http://www.usdoj.gov/atr/public/speeches/203627.htm. *See also* Alden F. Abbott, Associate Director for Policy and Coordination, Bureau of Competition, Federal Trade Commission, The Harmonization of Intellectual Property Rights and Competition Policy: A Unified Approach to Economic Progress, Remarks before the APEC High-Level Symposium on IPR, Xiamen, People's Republic of China (September 8, 2005) at 12 (compulsory licensing should be required only after a "patentee has been found on independent grounds to have violated the antitrust laws"), *available at* http://www.ftc.gov/bc/international/docs/abbottipchina.pdf.

technology. That might lessen private initiative and incentive to innovate.[15] Even when antitrust liability has been established, some commentators point to formidable "theoretical and practical problems"[16] with compulsory licensing and caution that "this remedy should be avoided where another, simpler remedy is available."[17] Most important among the difficulties cited in crafting an efficient compulsory licensing remedy is that it requires courts to act as administrators and price regulators.[18] Additionally, as the U.S. Supreme Court noted in *Trinko*, "compelling negotiation between competitors may facilitate the supreme evil of antitrust: collusion."[19]

At the other end of the spectrum, it also would not be prudent automatically to rule out the use of proprietary technologies in a standard, even if viable non-proprietary alternatives are available. The proprietary technology may prove superior and provide substantial benefits that would outweigh the potential costs. A blanket refusal to incorporate proprietary technologies could also inhibit innovation.

Given those considerations, an SSO's rejection of proprietary technologies would require careful scrutiny under U.S. antitrust law. In a 1985 case against the American Society of Sanitary

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[15] Delrahim, *supra* note 15, at 5 (concern with stifling innovation).

[16] Phillip Areeda, Louis Kaplan, Aaron Edlin, Antitrust Analysis (6th ed. 2004) ¶ 286 at 353.

[17] Delrahim, *supra* note 15, at 8.

[18] *See* Carl Shapiro, The Strategic Use of Licensing: Is There Cause for Concern About Unilateral Refusals to Deal?, Written Statement submitted to the U.S. Department of Justice and Federal Trade Commission Hearings on Intellectual Property and Antitrust (May 1, 2002), *available at* http://www.ftc.gov/opp/intellect/020501xscript.pdf.

[19] Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 408 (2004).

Engineering ("ASSE"),[20] the FTC challenged ASSE's policy of refusing to develop a standard for a product that is patented or manufactured by only one manufacturer, regardless of its merits. The case was settled with the issuance of a consent order that prohibited such blanket exclusions.

At the same time, SSO members may have legitimate concerns that the cost of utilizing a standard may be excessively high (and its commercial utility may be undermined) if patent rights unexpectedly are invoked after the standard has been adopted and implemented. Joint *ex ante* royalty negotiations among SSO members and patentees prior to adoption of a standard may be an effective way of dealing with this problem. Such negotiations could facilitate informed consideration of the comparative costs of alternative technologies that may be implicated by a standard. As such, *ex ante* negotiations should be assessed under the antitrust rule of reason, with full weight being given to the efficiencies they may engender as well as any potential anticompetitive aspects. In a speech last year, FTC Chairman Majoras noted that joint *ex ante* royalty negotiations can be a way of preventing the "hold up" problem and "can increase competition among rival technologies striving for incorporation into the standard," thus warranting rule of reason treatment.[21]

The interests of intellectual property rights holders and the standards community can best be mediated in a market-driven process in which the participants can make informed assessments of the costs and benefits of incorporating proprietary technology in a standard. Prospective users of a

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[20] *American Society of Sanitary Engineering*, Dkt. C-3169, 106 F.T.C. 324 (1985). The members of the ASSE include plumbing equipment manufacturers and designers.

[21] *Recognizing the Procompetitive Potential of Royalty Discussions in Standard Setting,* Remarks of Deborah Platt Majoras, Chairman, Federal Trade Commission, *prepared for* Standardization and the Law: Developing the Golden Mean for Global Trade, Stanford University (Sept. 23, 2005) at 7, *available at* http://www.ftc.gov/speeches/majoras/050923stanford.pdf.

standard have an understandable interest in knowing in advance what it might cost to use a standard. Likewise, standards organizations should be in a position to make informed decisions about the cost effectiveness of alternative standards. Accordingly, some standards organizations have a policy of requiring participants to disclose their intellectual property rights, even including applications for such rights, in technology being considered for inclusion in a standard. That may be a prudent policy as a contractual matter between a standards organization and its participants. It protects against the "hold-up" situation that I mentioned earlier. It should be up to each SSO, however, to determine what particular rules or policies best advance its interests. As long as those rules or policies are not anticompetitive, government should avoid second-guessing an SSO's decisions.

**V. <u>Summary and Conclusion</u>**

In sum, intellectual property plays a vital role in furthering economic progress and consumer welfare, and it is important to protect the incentives that promote the creation of intellectual property – namely, intellectual property rights. Intellectual property rights in the standard setting context are an increasingly important topic, because of the rapid expansion of intellectual property and the fact that many standards can only be practiced with licenses for intellectual property from one or more firms.

The relationships among intellectual property rights, standard setting, and the enforcement of competition laws are complex. Standard setting, often succeeded by intellectual property licensing, may raise the value of intellectual property. This may, in turn, promote economic growth by enhancing the rights holders' incentive to innovate. Every use of standard setting, however, may not be procompetitive. For instance, an intellectual property rights holder may use exclusionary conduct in an SSO to acquire, preserve or expand monopoly power. Proper application of the antitrust laws can counteract this competitive concern without undermining legitimate protection for intellectual property rights or deterring legitimate, procompetitive standards setting activity.

In short, the interests of intellectual property rights holders, affected producers, and consumers are often best mediated through a competitive, market-driven standard setting process characterized by transparency, arms' length negotiations, informed decision making, efficient licensing practices, and appropriate law enforcement. Such a market-driven process is most likely to produce an efficient standard that will both protect the legitimate rights of intellectual property rights holders and promote the interests of consumers.

Thank you again for giving me this opportunity to present my views and for your kind attention.