DEPARTMENT OF JUSTICE

Maximizing Incentives to Innovate Under China's Anti-Monopoly Law: Some Fundamental Principles

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I. Introduction

I am pleased to be here in Beijing to provide the perspective of the U.S. Department of Justice on the appropriate interface of antitrust and intellectual property law and policy, as China prepares to implement its new Anti-Monopoly Law. I would like to thank Professor Huang and the Competition Law Center, as well as T&D Associates, for inviting me to speak with you here in Beijing today.

This is not my first visit to this city. I first visited Beijing back when I was a student. I explored the great sites of the capital, climbed the Great Wall, rode a bicycle all over the place – it was a great adventure. In those days, Beijing was still very much what I would call a "horizontal" city. But even then, the cranes dotted the horizon, and tall buildings were starting to go up.

Today, Beijing is very much a "vertical" city, and like those tall buildings the city, and China, are reaching towards new heights. With the Olympic Games only a few months away, this is a particularly exciting time to be here. The Olympics are competition at the highest level. Athletes from around the world have prepared for years for this moment, made sacrifices and investments, and taken risks just to have this opportunity to compete and, hopefully, to win. They will soon see whether those risks will pay off.

The Olympics are all about competition, and while I suspect no one in this room has ever competed for Olympic gold those of us who work in the antitrust field appreciate the benefits that competition brings. Antitrust is all about encouraging and protecting that competition. Like Olympic athletes, companies should be encouraged to strive for excellence by competing vigorously. Like Olympic athletes, companies that have made sacrifices and taken risks should be free to enjoy the fruits of their victories when they succeed. Whether we are talking about

Olympic medals, leading market positions, or intellectual property, the principle is the same: the promise of the rewards of victory encourages competitors to enter the arena, and competition brings out the best in those who compete.

This is why antitrust laws are considered part of the foundation of the American economy, and it is why the United States is so pleased that China has achieved the significant milestone of adopting its own Anti-Monopoly Law after thirteen years of deliberation, and that on August 1 China will join the more than 100 nations that have established antitrust enforcement regimes. We appreciate very much the opportunities we have had over the years to discuss the development of the AML with Chinese government officials and academic experts, and we are looking forward to continuing this relationship as China implements the Anti-Monopoly Law.

Today I would like to talk specifically about plans for implementing the AML as it applies to the exercise of intellectual property rights.[1] There is, naturally, a lot of interest both inside and outside China in knowing exactly which activities will be deemed the mere exercise of intellectual property rights and which will constitute an "abuse" of intellectual property rights. More importantly, it is crucial to maximize the economic benefits of innovation and improve consumer welfare through the right combination of respect for intellectual property rights and preservation of competitive markets. China would do well to learn from the successes and mistakes of the United States when developing its approach to analyzing intellectual property rights within the context of the AML. Indeed, a number of fundamental principles derived from our experience would serve as good guideposts as China begins to implement the new law

[1] Article 55 of the Antimonopoly Law states: "This Law is not applicable to the undertakings which use intellectual property rights according to the laws and administrative regulations relevant to intellectual property, but is applicable to the undertakings which abuse intellectual property and eliminate or restrict market competition." Anti-monopoly Law of the People's Republic of China, Art. 55 (2007) (informal translation), *available at* https://www.amcham-china.org.cn/amcham/upload/wysiwyg/20070906152846.pdf.

because they would provide clarity, reduce uncertainty, generate confidence that the analysis does not mask an arbitrary process, and preserve incentives to innovate.

II. Antitrust Analysis of Intellectual Property Rights Should Preserve Innovation Incentives

Innovation drives economic growth in developed economies because it promotes consumer welfare and economic efficiency through technological change in at least three important ways. First, innovation can lower costs through the creation of more efficient methods of production, distribution to markets, and delivery to consumers. Second, the introduction of new and better products can stimulate economic growth if they are products that consumers wish to buy. And third, the development of new technologies that leap over existing technologies can facilitate the entry of new competitors seeking to take the place of today's dominant firm.

There is no doubt that consumers are better off when innovation is encouraged and nurtured, from the spark of the new idea to the commercial processes needed to bring new products and services to market. Innovation is fostered by many factors, but two important sources of innovation are robust systems of intellectual property rights and competitive markets. Antitrust laws, which protect and enhance competitive markets, and intellectual property laws complement each other by working towards the same fundamental goals of enhancing consumer welfare through innovation. Intellectual property laws promote innovation by creating legally cognizable exclusive rights to protect ephemeral "inventions and ideas," which reward the creators of these inventions and ideas. Utilizing these exclusive rights, intellectual property owners can sell their valuable intellectual property or commercialize their inventions.

But intellectual property laws alone are not enough. Competition in open markets also is needed to foster innovation. Looking over one's shoulder at the nearest competitor provides motivation to invest in research and development to be the first to bring a new product to market,

to improve products already introduced, or to leap-frog over existing products. When enforcing our antitrust laws, we seek to maximize innovation incentives by respecting intellectual property rights where appropriate and by challenging illegal collusive or exclusionary conduct involving such rights.

III. The U.S. Experience: From the Nine No-Nos to a Full Tool Box

It has taken the U.S. antitrust enforcers many years to develop policies to guide businesses and consumers about when the use of an intellectual property right is likely to violate the U.S. antitrust laws. In the past, the Antitrust Division of the U.S. Department of Justice sought to prevent patent holders from extending the reach of their patent through contracts with their licensees by announcing that nine contractual restrictions would violate the antitrust laws.[2] These practices came to be known as the "Nine No-Nos."

By the 1980s, the Division understood that this approach was too narrow because it did not take into account the ways in which some restrictions in licensing agreements, over the long-term, can actually be used to increase competition. Certain licensing restraints may encourage licensees to develop the patent owner's technology, for example, or they may reduce the cost of licensing, or reduce the cost of production. Instead of reflexively saying "no" to specific intellectual licensing practices, we learned to examine them on a case-by-case basis to determine whether they, in fact, cause more good than harm. This is known as a rule of reason effects-based analysis.

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[2] *See* Bruce B. Wilson, Deputy Assistant Attorney Gen., U.S. Dep't of Justice, Patent and Know-How License Agreements: Field of Use, Territorial, Price and Quantity Restrictions, Remarks Before the Fourth New England Antitrust Conference 19 (Nov. 6, 1970), *reprinted in* ANTITRUST PRIMER: PATENTS, FRANCHISING, TREBLE DAMAGE SUITS, PROCEEDINGS OF THE FOURTH NEW ENGLAND ANTITRUST CONFERENCE 11 (Sara-Ann Sanders ed., 1970) (identifying: 1) tying unpatented supplies to patented products, 2) compulsory exclusive grantback clauses, 3) vertical distribution restraints, 4) ties, 5) veto power by licensees over the issuance of further licenses, 6) mandatory package licensing, 7) royalties on total sales, 8) restraining sales of unpatented products made by a patented process, and 9) minimum price maintenance).

In 1995, the Department and the Federal Trade Commission ("FTC") issued antitrust guidelines for the licensing of intellectual property. We made clear in those guidelines – which are available on our agencies' respective websites – that it is appropriate to evaluate the vast majority of intellectual property licensing arrangements under the rule of reason – in other words, that such agreements are not "per se" unlawful. Exceptions arise only in those rare cases where the "nature and necessary effect" of a licensing restraint are "so plainly anticompetitive that [the restraint] should be treated as unlawful per se," such as where intellectual property transactions are used to cover naked price-fixing agreements, market allocations among horizontal competitors, or certain group boycotts.[3]

Let us look at patent pools as an example. Before the issuance of the 1995 Antitrust-IP Guidelines, many U.S. businesses avoided creating patent pools. Through section 5.5 of these guidelines, the Agencies explained that fear of antitrust liability need not prevent creation of a patent pool, so long as that pool was not used as a sham mechanism to accomplish naked price fixing or market allocation. In most cases, the rule of reason is the appropriate tool to determine whether the benefits of any particular pool are more significant than the potential harms. Section 5.5 identifies several procompetitive benefits that can arise when multiple patent holders create a patent pooling arrangement designed to promote the dissemination of technology by facilitating access to multiple patents.[4] Section 5.5 also identifies the potential harms of patent pools, including reducing price competition between licensors or discouraging innovation. Not long after the Antitrust-IP Guidelines were issued, some technology groups sought to capitalize on

[3] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY § 3.4 (1995) (citations omitted), *available at* http://www.usdoj.gov/atr/public/guidelines/0558.pdf [hereinafter ANTITRUST-IP GUIDELINES].

[4] ANTITRUST-IP GUIDELINES § 5.5 (procompetitive benefits include integrating complementary technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation).

this guidance and reap the procompetitive benefits of patent pools while implementing a number of safeguards designed to minimize the anticompetitive risks associated with such arrangements.[5]

The 1995 Antitrust-IP Guidelines are an excellent product that still serves us well, and yet we continue to study these issues and refine our thinking based on new knowledge and new understanding. Our continued study is motivated by the fact that the antitrust-intellectual property crossroad is fertile ground for analysis by academics (both legal and economic), by practitioners, and by industry members. Seeking to harness this knowledge, the Division and the FTC held a year's worth of hearings about antitrust and intellectual law and policy. On the basis of these hearings, we issued a report in April 2007, known colloquially as "the IP2 Report," that provided policy guidance on a number of intellectual property-related specific practices.[6]

In addition, the Division's business review letter process allows us publicly to address specific policy questions about prospective business arrangements in great detail. When businesses desire guidance from the Department about a specific future course of conduct, they may submit a formal request for our views. After conducting an investigation, we issue a letter that states our enforcement intentions regarding the proposed activity and explains our analysis. Using this format, we have addressed the competitive impact of a number of activities involving intellectual property, including patent pools and patent disclosure policies of standard-setting

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[5] *See* Letter from Joel I. Klein, Acting Assistant Attorney Gen., U.S. Dep't of Justice, to G[a]rrard R. Beeney, Esq. (June 26, 1997), *available at* http://www.usdoj.gov/atr/public/busreview/215742.pdf; Letter from Joel I. Klein, Assistant Attorney Gen., U.S. Dep't of Justice, to Garrard R. Beeney, Esq. (Dec. 16, 1998), *available at* http://www.usdoj.gov/atr/public/busreview/2121.pdf; Letter from Joel I. Klein, Assistant Attorney Gen., U.S. Dep't of Justice, to Carey R. Ramos, Esq. (June 10, 1999), *available at* http://www.usdoj.gov/atr/public/busreview/2485.pdf.

[6] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST ENFORCEMENT & INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION (2007), *available at* http://www.usdoj.gov/atr/public/hearings/ip/222655.pdf [hereinafter IP2 REPORT] (addressing refusals to license patents, certain standard-setting activities, cross-licensing and patent-pooling agreements, licensing practices, IP bundling, and the temporal extension of patent rights). We refer to this report as IP2 to distinguish it from an earlier report issued by the Federal Trade Commission. FED. TRADE COMM'N, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY (2003), *available at* http://www.ftc.gov/os/2003/10/innovationrpt.pdf.

organizations.[7] These various formats allow our guidance to evolve and expand to cover new topics over time as needed.

IV. Fundamental Principles for China's Implementation of the Anti-monopoly Law that Can Be Drawn from the U.S. Experience

As China begins to operate under the AML, Chinese consumers will get the most economic benefit if enforcers ensure that activities involving intellectual property rights actually harm competition before they are found to violate the AML, as would be the case with any other form of property. This can be accomplished through the adoption of several fundamental principles of analysis. Enforcement of the AML that is grounded in these principles will be less likely to harm innovation incentives, and will therefore help maximize China's economic growth and development, to the ultimate benefit of China's consumers. Such enforcement also would encourage foreign investors to continue technology transfers.

I would like to offer the following fundamental principles, which are based on the U.S. experience and which would provide such guidance without limiting the evolution of the AML:

1. The same antitrust rules should be applied to intellectual property as to other forms of property.

By applying the same rules to all forms of property, an antitrust enforcement authority signals its adoption of the view that antitrust and intellectual property laws work together to promote innovation and competition, and that the antitrust laws will not be used to narrow the reach of rights granted through the intellectual property laws. Moreover, such different rules for

[7] *E.g.*, patent pooling business review letters, *supra* note 5; Letter from Thomas O. Barnett, Assistant Attorney Gen., U.S. Dep't of Justice, to Michael A. Lindsay, Esq. (Apr. 30, 2007), *available at* http://www.usdoj.gov/atr/public/busreview/222978.pdf (business review issued to Institute of Electrical and Electronics Engineers, which develops a wide range of technology standards); Letter from Thomas O. Barnett, Assistant Attorney Gen., U.S. Dep't of Justice, to Robert A. Skitol, Esq. (Oct. 30, 2006), *available at* http://www.usdoj.gov/atr/public/busreview/219380.pdf (business review issued to trade association that develops standards for certain computer bus architecture).

the antitrust treatment of intellectual property rights are not needed because the distinguishing characteristics of intellectual property can be taken into account by common antitrust principles.

2. It should be recognized that an intellectual property right does not necessarily create market power.

Market power is the ability profitably to raise prices or reduce output for a significant period of time. One of the fundamental rights associated with an intellectual property right is the ability to exclude others from using the specific product, process or work, but it does not necessarily follow that an intellectual property right confers market power. For example, a firm that sells a patented product may have significant intellectual property rights in that product, but those rights will not give the firm market power if there are many actual or potential close substitutes for the product to which consumers can turn. Relying on a presumption of market power is harmful if it permits a finding of an antitrust violation when none should exist.

3. Protect competition, not individual competitors.

The goal of an antitrust regime should be to protect and enhance competition and consumer welfare. To achieve these goals, antitrust enforcers must work to eliminate harm to competition and not be distracted by complaints that merely focus on harm to individual competitors. It is only when competition as a whole is harmed that the welfare of consumers suffers. We want companies to compete, for that is what antitrust is all about, and it is inevitable that, as a result of that competition, some firms will win and others will lose. After all, not every athlete in the race gets a medal. The Olympic Games would not be nearly as exciting if they did.

Here I should perhaps pause to make what I believe is a fundamental point about the interface between antitrust and intellectual property. Strong intellectual property protection is *not separate* from competition principles, but rather, is *an integral part* of antitrust policy as a

whole. Intellectual property rights should not be viewed as protecting their owners *from* competition; rather, like Olympic glory they should be seen as encouraging firms to engage *in* competition in the first place, particularly competition that involves risk and long-term investment. Properly applied, strong intellectual property protection creates the competitive environment necessary to permit firms to profit from their inventions, which encourages innovation effort and improves dynamic efficiency.

As Assistant Attorney General Tom Barnett has noted, such a competitive environment is like the goose that lays golden eggs in the classic fable (which I won't explain because I am sure it has its roots in a Chinese fable):

> Nurturing such an environment has created innumerable golden eggs in the U.S.: the telephone, the phonograph, light bulbs, lasers, computers, television, and countless new drugs and medical devices. Once these breakthrough inventions exist, however, it can be tempting to carve up the benefits and spread them around the economy. When Christmas dinner approaches, it is tempting to think, why not carve up the goose itself? We can find fault with the goose: she ought to be laying more eggs, and she might even be keeping an egg or two for herself. But we all know the moral lesson to this story. When you kill the goose, you end up without the eggs, and you quickly learn that the one big meal was not worth the long term cost.[8]

4. Recognize that intellectual property licensing agreements are likely to be procompetitive.

Intellectual property rights can gain value when they can be licensed to be used with other factors of production, such as manufacturing facilities, distribution facilities, and workers. Such licensing agreements can benefit competition if they decrease costs and make it easier to bring new products to market, if they increase the extent to which intellectual property rights are

[8] Thomas O. Barnett, Assistant Attorney Gen., U.S. Dep't of Justice, *Interoperability Between Antitrust and Intellectual Property*, Address at the George Mason University School of Law Symposium on Managing Antitrust Issues in a Global Marketplace, 5 (Sept. 13, 2006), *available at* http://www.usdoj.gov/atr/public/speeches/218316.pdf.

utilized, or if they increase the value of intellectual property rights and stimulate investments in additional research and development.

5. Undertake case-by-case, effects-based analysis rooted in sound economics.

The possession of intellectual property does not necessarily confer market power, but even when an IP holder does have such power the mere existence of that power is not a sufficient basis for an antitrust violation. Indeed, "[w]hen innovation leads to dynamic efficiency improvements and a period of market power, it is not a departure from competition, but it is a particular type of competition, and one that we should be careful not to mistake for a violation of the antitrust laws."[9] It is often the lure of monopoly profits that encourages entrepreneurs to take the risks necessary to promote economic growth through technological innovation. This innovation leads to what economist Joseph Schumpeter called the force of "creative destruction" in which old dominant firms are replaced by innovative competitors.[10] Here is one modern example: Many young Americans have abandoned the compact discs of their "old" parents, preferring instead to compile their own play lists by downloading individual songs from Internet stores to their iPods and other portable MP3 players. The result: sales of CDs have plummeted and a new point of sale technique, digital delivery over the Internet, is thriving, at least until it too is overtaken by the next innovation surge.

Therefore, in addition to a finding of market power, it is also necessary to engage in effects-based analysis to determine whether competition has been harmed by the foreclosure of market entry, engagement in unlawful coordination, or unreasonable reduction in incentives to innovate through the exercise of that power. In effects-based analysis, the focus is on the

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[9] Thomas O. Barnett, Assistant Attorney Gen., U.S. Dep't of Justice, *Maximizing Welfare Through Technological Innovation*, Address at the George Mason University Law Review 11th Annual Symposium on Antitrust, 17 (Oct. 31, 2007), *available at* http://www.usdoj.gov/atr/public/speeches/227291.pdf.

[10] JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 87 (Harper Perennial ed. 1976) (1942).

economic effect of the activity or licensing restriction, not on its form. Focusing on the economic effect avoids condemning activities that enable competitors to engage in business strategies that ultimately benefit consumers.

6. Recognize the benefits to consumer welfare that flow from intellectual property rights.

Finally, any analysis of intellectual property rights under the AML should be sensitive to the long-term contribution that these rights make to consumer welfare and economic growth. Over-aggressive enforcement, such as finding liability under the AML without finding harm to competition, could chill future procompetitive innovation and investment. Enforcers should also take into account the impact that specific enforcement actions, such as attacking royalties that are perceived to be too high, may have on future investments in innovation or the willingness of foreign companies to license their technologies in China.

V. Conclusion

Relying on these six fundamental principles would ensure that China's anti-monopoly enforcement authorities do not use the AML to challenge actions that have not been shown to harm competition. It would also allow China to avoid issuing a long list of prohibited activities involving intellectual property rights. Keep in mind that almost every jurisdiction that has issued a long list of forbidden categories of conduct has had to go back and revise their analysis after learning, from their enforcement experience or from scholars, that many of those activities have the potential to promote competition rather than harm it. The U.S. certainly had to do this: remember the "Nine No-Nos"?

An additional benefit of using these fundamental principles is that they could form part of the basis for reconciling the older, apparently per se illegal approach found in several other Chinese laws that address "unfair" intellectual property licensing practices, such as China's

Contract Law and Foreign Trade Law,[11] with the AML, which takes into account both the procompetitive benefits and the anticompetitive harms of an activity.[12]

I think it would be appropriate for China's antitrust enforcement authorities to rely on these fundamental principles for an extended period of time. During this time, China can develop its own enforcement policy experience through thoughtful case-by-case analysis and learn first-hand the potential procompetitive benefits and anticompetitive harms of specific activities involving intellectual property rights. After such a period of time, a review of the Chinese cases decided during the initial enforcement period and a survey of the antitrust-IP guidelines and cases of other jurisdictions might appropriately lead to the development of more specific guidelines should China's experience suggest that they would be useful.

Rather than attempting immediately to issue anti-monopoly regulations or guidelines that address the application of the AML in the context of intellectual property rights, I suggest that China develop fundamental principles, based on our experience, so as to maximize the economic benefits that come from innovation and competition. Such principles will increase the likelihood that the new anti-monopoly law will improve the welfare of Chinese consumers.

Thank you for inviting me to speak with you today.

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[11] *See, e.g.*, Contract Law of the People's Republic of China, Art. 329 (1999) (declaring null and void technology contracts that "monopolize a technology or impede technological progress."); Interpretation of the Supreme People's Court concerning Some Issues on Application of Law for the Trial of Cases on Disputes over Technology Contracts, Art.10 (Nov. 30, 2004) (identifying as illegal under Article 329: (1) exclusive grant backs; (2) non-reciprocal conditions on the use of improvements to the technology; (3) restrictions on licensing competing technologies; (4) requirements to license technology that is not essential to the implementation of the primary technology; (5) requirements to purchase inputs from specified sources; and (6) unreasonable restrictions on the quantity, variety, sales channels or export of products using the licensed technology); Foreign Trade Law of the People's Republic of China, Art. 30 (2004) (prohibiting obligations not to challenge the validity of the licensed intellectual property rights, forced package licenses, and exclusive grant back clauses).

[12] Anti-monopoly Law of the People's Republic of China, Arts. 13, 14, 15, 17.