Antitrust Enforcement with Respect to Intellectual Property in China

Fay Zhou, Xi Liao & Christoph Barth (Linklaters LLP)

Enforcement activity at the intersection of antitrust and intellectual property ("**IP**") rights is one of the hot topics these days and heavily debated among practitioners and industry participants in the US and EU. It is widely recognised that antitrust and IP law share the common purpose of promoting innovation and enhancing consumer welfare and are thus complementary instruments. Antitrust law seeks to promote consumer welfare by prohibiting certain actions that may harm competition with respect to either existing or new ways of serving consumers. IP law grants technology owners a monopoly to reward them for the development of the respective technology and incentivise further innovation. In the absence of IP law, rapid imitation would chill innovation, ultimately to the detriment of consumers. It is thus recognised that antitrust enforcement in this area should be limited and primarily focus on transactions capable of lessening competition among rival technologies, while other enforcement action may interfere with the principal goals of IP rights. Attempts to restrain licensing fees in the short term can thus undermine incentives to invest and thereby slow down innovation and economic growth.

China is still a comparatively new player in the antitrust world but has grown quickly and is clearly one of the most important emerging jurisdictions for enforcement. Recently enforcement of China's Anti-Monopoly Law ("**AML**") has started to come across the intersection with IP law and this article seeks to explore the developments in this area. It summarises the important enforcement cases and legislative initiatives by the Chinese antitrust agencies involving IP in both conduct rules and merger review in recent years. It also discusses the key notable features of the authorities' enforcement activities, and presents the implications for IP-rich companies and IP-based business models operating in China and beyond. For this purpose, private litigation is not discussed in this article.

1 Active IP-related enforcement

By way of background, the enforcement powers of the AML are split between three agencies:

- The National Development and Reform Commission ("**NDRC**") is responsible for investigating and sanctioning anti-competitive agreements, abuses of a dominant market position that relate to pricing conduct.

- The enforcement powers of the State Administration for Industry and Commerce ("**SAIC**") cover essentially the same types of conduct as NDRC but where the conduct does not relate to pricing.

- The third government authority, the Ministry of Commerce ("**MOFCOM**"), is solely responsible for reviewing concentrations of undertakings.

This section focuses primarily on enforcement initiatives launched by NDRC and SAIC against anti-competitive agreements and abuse of dominance relating to IP.

1.1 Qualcomm case

On 9 February 2015, NDRC issued a decision against US semiconductor giant Qualcomm, imposing a record penalty of RMB 6.088 billion (approximately USD 975 million), which equals approximately 8% of Qualcomm's China revenue in 2013, and a set of remedies around the company's patent licensing practices. The *Qualcomm* case marks a new record for the highest individual fine in China, which exceeds by far the largest fine handed down by NDRC under the AML in a single case (RMB 832m, USD 136m in the auto parts cartel) and against a single company (RMB 290m, USD 47m against Sumitomo Electric).

The decision came after more than 15 months of investigation and lengthy remedy-discussions involving – according to statements made by Qualcomm – more than 20 meetings between officials and company representatives. NDRC's investigation into Qualcomm reportedly was prompted by complaints from some competitors and industry associations, most notably Mobile China Alliance, which represents China's powerful mobile phone industry, and the Internet Society of China in early November 2013. After receiving complaints and reviewing the accompanying evidence, NDRC carried out simultaneous dawn raids at Qualcomm's offices in Beijing and Shanghai. It was reported that NDRC had assigned up to 80 officials to the case, which marks a record in the regulator's investigations and highlights the substantial resources NDRC can mobilise. In addition, NDRC teamed up with some external advisers in order to comb through the substantial volume of data collected. Throughout the process, NDRC co-operated closely with the Ministry of Industry and Information Technology ("**MIIT**"), the Chinese telecom and internet regulator.

In the decision, which was published on 2 March 2015, NDRC defined separate markets for the licensing of each wireless communications standard essential patent ("**SEP**"), which is consistent with the approach adopted by Chinese courts in the earlier *InterDigital* case and broadly in line with EU and US practice. The case therefore related to a collection of relevant SEP licensing markets and three separate downstream markets for certain types of baseband chips. NDRC found Qualcomm to hold a dominant position in each of the SEP markets by virtue of its 100% market share and its ability to control pricing. Further, NDRC held that Qualcomm (exceeding the presumption market share threshold of 50%) is also dominant in the relevant downstream markets. For this purpose NDRC assessed by value market shares and held that the higher average selling pricing which Qualcomm was able to impose on its customers was supportive of a dominant position.

NDRC subsequently analysed a number of alleged anti-competitive practices and found that Qualcomm charged excessive royalties by (i) requiring Chinese licensees to cross-license their patents to Qualcomm and its customers free of charge, (ii) bundling SEPs and other patents (of uncertain value), (iii) imposing patent rates based on the net wholesale price of the device, (iv) failing to disclose complete lists of patents to other market participants and (v) not modifying royalties upon expiry of a patent. Further, NDRC found a violation of Article 17 AML by virtue of bundling SEPs and non-SEPs without justification and by imposing certain restrictions on its licensees (such as a covenant not to challenge the licence agreement).

Qualcomm ultimately offered a series of commitments to close the case with NDRC and to avoid an even higher fine. Specifically, it agreed to lower its royalties by 35%. However, Qualcomm is still entitled to base the calculation of its royalties on the net wholesale price instead of the value of the smallest saleable unit (as suggested by the MIIT), which was a heavily debated question in the course of the proceedings. It could thus preserve some elements of its royalties formula and avoid a duty to license at the chip level, which might have led to patent exhaustion. Further, Qualcomm committed not to charge wireless communications device makers within mainland China for expired patents and to disclose complete lists of relevant SEPs. It is required to negotiate in good faith with Chinese cross-licensees, to offer a fair compensation when seeking a cross-licence and to stop bundling SEPs and non-SEPs without justification. The latter commitment will be of particular importance for patent-rich licensees who had to bear additional opportunity costs when licensing their patent pool under a free-of-charge cross-licence agreement.

That said, Qualcomm would still be entitled to refuse to sell chips using its patents if the other party is not willing to enter into a licence agreement. Also Chinese cell phone manufacturers, will continue to be required to report their sales of licensed devices to Qualcomm in order to determine the royalties to be paid. The NDRC decision does not contain an explanation of an accepted approach for calculating fair, reasonable and non-discriminatory ("**FRAND**") royalties.

One novel feature of this case is that some remedies are not part of NDRC's decision but have been given orally as a means of avoiding possible follow-on litigation. Further, it is noteworthy that NDRC reviews excessive pricing practices to regulate the pricing of patent holders (an area in which US and – to a less extent – EU agencies are reluctant to initiate cases). On the procedural aspect, in an effort to increase transparency, NDRC held a press conference to brief the public the case and later published the fully reasoned decision. These are commendable as they provide insights into the agency's approach and valuable predictability to the businesses.

1.2 Other cases

While NDRC's enforcement practice was initially focused on cartels and resale price maintenance, it started dedicating significant resources to abuse of dominance investigations from 2013 onwards, when it launched an investigation of US-based patent licensing company InterDigital (and subsequently the *Qualcomm* investigation).[1]

The allegations against InterDigital were broadly similar to those in the *Qualcomm* case, focusing on unfairly high licensing fees for SEPs as well as cross-licensing and bundling practices involving SEPs and non-SEPs. Following a settlement with Chinese devices manufacturer Huawei in a parallel lawsuit, with regard to patent licensing fees and other items, InterDigital committed to refer to its agreements with Huawei when negotiating licensing fees and other conditions with other Chinese companies. Subsequently, NDRC suspended the probe pursuant to Article 45 of the AML in March 2014.

It is reported that currently there are also other cases pending with NDRC which relate to patent licensing or assertion practices (such as multimedia licensing companies Dolby Labs and HDMI Licensing). Further, the authority appears to be taking aim at IP issues in the pharmaceutical sector. Starting in 2014, the regulator rolled out an industry-wide inquiry among international pharmaceutical companies on the price differences for patent drugs in China compared to other jurisdictions.

On SAIC's side, SAIC launched an investigation against Microsoft alleging abuse of dominance (including tying) in July 2014. The agency said it had conducted three raids of Microsoft's office premises and several rounds of interviews with the company's staff. Further, SAIC noted that it is currently reviewing the information gathered, and Microsoft has submitted explanatory papers and additional information as required. At this stage it is unclear whether and when a decision will be issued.

2 Legislative initiatives

In parallel with active enforcement action, the agencies are also making efforts to draft implementing regulations in relation to the interplay of antitrust and IP, with an aim to provide guidance to the business community. On April 7th 2015, SAIC released its long-awaited *Provisions on Prohibition of Abuse of Intellectual Property Rights to Eliminate or Restrict Competition* ("**IP Regulation**"), after no less than five years of research, consultations, drafting, and at times heated debates with stakeholders. The IP Regulation, which will take effect as of 1 August 2015, marks a watershed for antitrust law and IP in China.

As SAIC is tasked with enforcing the AML against non-price-related anti-competitive conduct, the scope of the IP Regulation is limited to SAIC's own enforcement remit and it does not apply to price-related anti-competitive conduct (which falls within the jurisdiction of NDRC) or IP issues arising in the context merger control. Notwithstanding, the IP Regulation is China's first comprehensive implementing regulation addressing the exercise of IP and signals that SAIC is prepared to intensify enforcement in this area. Also, it is expected that other Chinese regulators will refer to the IP Regulation in the context of their own enforcement activities. Further, NDRC has explained that it is currently working on a revised version of the IP regulation, broadening its scope so that it directly applies to all types of anticompetitive behaviour.

2.1 Anti-competitive agreements

Consistent with the AML's general prohibition on anti-competitive agreements, the IP Regulation confirms that undertakings are prohibited from entering into either horizontal or vertical monopoly agreements involving IP. Notably, the IP Regulation introduces "safe harbour" provisions, which were heavily debated during the drafting process. Agreements between undertakings will not be considered to be anti-competitive if the parties' market shares are below certain thresholds:

(i) for horizontal agreements: 20% combined share in the affected market, or if four or more substitutable technologies, controlled by entities independent of the parties, are available at reasonable price;

(ii) for vertical agreements: 30% share in each of the upstream and downstream markets or if two or more substitutable technologies, controlled by entities independent of the parties, are available at reasonable price.

The safe harbour thresholds resemble the equivalent rules in the European Commission's Technology Transfer Block Exemption Regulation ("**TTBER**"), which was amended in 2014. Nevertheless, while the rationale behind the "safe harbour" provisions is laudable, parties to agreements involving IP may find it difficult to gain comfort in practice. Such market share thresholds involve a complex assessment of what constitutes a "relevant market" for antitrust purposes, and an even more complex assessment of whether alternative technologies are "substitutable" and available at prices that are "reasonable". Moreover, the IP Regulation adds a caveat: the exemption does not apply if SAIC establishes that an agreement has the effect of eliminating or restricting competition, which introduces an additional great degree of uncertainty.

2.2 Abuse of Market Dominance

The IP Regulation identifies certain behaviours that SAIC will consider as an abuse of a dominant market position, unless the conduct can be justified (for which the burden is on the relevant company under investigation): (i) refusal to license essential IP; (ii) exclusive dealing; (iii) tying/bundling; (iv) attaching unreasonable trading conditions; and (v) discriminatory treatment to equivalent transactions. This list is non-exhaustive and does not prevent SAIC from also considering other types of conduct to be abusive.

Refusal to license.

The IP Regulation for the first time introduces an "essential facilities doctrine", a controversial concept in antitrust enforcement worldwide. When considering an IP holder's refusal to license IP, SAIC will take into account:

(i) whether reasonable substitutes for the IP exist, and whether the IP is necessary for the licensee to compete in the relevant market;

(ii) whether the refusal will have an adverse impact on competition or innovation, to the detriment of consumer interest or public interest; and

(iii) whether licensing the IP to the licensee will cause unreasonable harm to the IP holder.

During consultations of drafts preceding the IP Regulation, the circumstances under which a refusal to license would breach the AML were fiercely debated. Very likely, the final text continues to be a source of concern for many IP holders, due to the fact that it seemingly sets a low threshold for compulsory licensing. This stands in contrast to the approach taken in other jurisdictions. For instance, in the EU, a refusal to license will only amount to an abuse of dominance in "exceptional circumstances". Similarly, the US courts have also imposed duties to deal on dominant firms in highly specific situations. It is yet to be seen how SAIC would apply this doctrine in practice, but the emergence of a Chinese enforcement practice that disincentivises innovation would be deeply unfortunate.

Unreasonable trading conditions.

The IP Regulation further prohibits the imposition by a dominant IP holder of unreasonable conditions on its licensees without justification. The regulation lists a non-exhaustive list of unreasonable conditions, including:

(i) exclusive grant-backs of the licensee's improvement to licensed technologies;

(ii) no-challenge clauses prohibiting a licensee from challenging the validity of the licensed IP;

(iii) restrictions on the use of competing products or technologies after expiry of the licence agreement;

(iv) obligations to pay royalties after the expiry or invalidation of the licensed IP; and

(v) exclusive dealing.

This scepticism about exclusive grant-back and no-challenge clauses is in line with the approach taken in the TTBER in the EU. Under the TTBER regime, technology licence agreements containing such clauses are not exempted from the EU rules on restrictive agreements. The TTBER also removes the benefit of the exemption for termination clauses, which allow the licensor to terminate the technology licence agreement if the licensee challenges the validity of the IP, as the European Commission considers that such termination arrangements can have the same deterring effect as no-challenge clauses. It is unclear in the IP Regulation (albeit possible) that SAIC will consider that a termination clause is already covered as one type of non-challenge practice.

Patent pools.

The IP Regulation also addresses anti-competitive conduct in the context of patent pools. Under the IP Regulation, patent pool members are prohibited from entering into anti-competitive agreements through the exchange of competitively sensitive information relating to output, market allocation, etc. In addition, unless justified, patent pools with a dominant market position are not allowed to:

(i) prevent members from individually licensing outside the pool;

(ii) prevent members or licensees from developing competing technologies on their own or in co-operation with third parties;

(iii) require exclusive grant-backs;

(iv) prohibit licensees from challenging the validity of the pooled patents; or

(v) apply different trading conditions to equivalent transactions.

Notably, a patent pool can, as provided in the IP Regulation, take the form of a specialised joint venture company tasked with managing the patent tool. This could constitute a concentration of undertakings under the AML, and, if the relevant turnover thresholds are also met, would trigger a merger control filing to MOFCOM. In this situation, MOFCOM will undertake assessment of the competition issues in relation to the proposed establishment of the joint venture company, including any clauses referenced above. It is unclear whether and how SAIC will co-ordinate with MOFCOM during the latter's review process (which may take place prior to SAIC's intervention on its own).

Standard Setting.

The IP Regulation contains provisions that are intended to regulate abusive conduct by dominant IP holders during the standard setting process. It will be considered an abuse of dominance if a patentee deliberately conceals patent information or waives the right of assertion during the standard setting process, but nevertheless asserts the patent after a certain standard has incorporated the patent. It will also constitute an abuse if an SEP holder refuses to license the SEP, tying in licensing, or imposing unreasonable conditions in violation of the FRAND-principle.

Other IP-related abusive conduct.

Exclusive dealing, tying and discrimination in the exercise of IP are also prohibited under the IP Regulation. However, the clauses related to these types of conduct largely mirror the wording of the general provisions of the AML, and no further details have been provided with regard to the application to the exercise of IP.

Notably, some provisions, which appeared in the previous drafts, were removed from the final version. For instance, the draft released for public comment on 11 June 2014 attempted to regulate copyright collecting societies, because SAIC believed that such conduct could potentially restrict competition. More specifically, the public consultation draft prohibited anti-competitive agreements between a copyright collecting society and copyright owners, and between copyright collecting societies, and further outlawed abusive conduct in the forms of refusal to license; discriminatory treatment; obligations imposed upon licensees to accept unwanted copyrights; and preventing copyright owners from removing themselves from the society. These provisions have been removed from the final regulation. In addition, the public consultation paper also sought to prohibit dominant IP holders from sending abusive warning letters after the IP has expired or become invalid. This prohibition also does not appear in the final version. These provisions were removed presumably because they provoked controversies, which were not successfully settled.

The IP Regulation represents a step forward in laying out a general framework on how to apply the AML to the IP field. In the past, antitrust regulation in relation to IP in China was scattered in a variety of laws and regulations, such as the Patent Law, the Contract Law and the relevant judicial interpretations of the Supreme Court. This has resulted in a lack of clarity in terms of what constitutes anti-competitive conduct in the IP field. In this regard, the IP Regulation has provided some welcome guidance to market players. The rules have not departed significantly from internationally recognised approaches, but certain clauses (e.g. those dealing with refusal to license) may still cause concerns among IP holders.

While SAIC has endeavoured to provide more clarity to market players by enacting the IP Regulation, there is still a lack of guidance for behaviours that fall under the jurisdiction of the other two regulators, NDRC and MOFCOM. This stands in contrast to the existence of comprehensive regulations and guidelines in relation to the application of the AML to IP issues in the EU and the US.[2]

3 Review of mergers involving IP issues

Since the AML's entry into force in 2008, China's merger regulator MOFCOM has imposed IP-related remedies in 10 cases out of a total of 24 conditionally approved transactions. This demonstrates the increasing scrutiny that the agency applies to IP issues in assessing mergers. This section discusses two merger cases in particular, the *Microsoft/Nokia* case in detail and the *Google/Motorola Mobility* case briefly. In both cases, IP is the focal point in the regulator's assessment.

3.1 Microsoft/Nokia

On 8 April 2014, MOFCOM conditionally approved Microsoft's acquisition of Nokia's Devices & Services Business following a 180-day extended Phase 2 review. The decision shed light on the evolving approach taken by MOFCOM in its analysis of patent portfolios in consumer technology markets. The behavioural commitments are unusual in including third-party licensing obligations not only on the merging firms, but also on the seller.

The merged entities did not overlap horizontally in any relevant markets and had low shares in neighbouring markets. MOFCOM found that the target business had a smartphone market share of only 4.85% globally and 3.7% in China. Similarly, MOFCOM held that Microsoft's market share in the market for smart mobile device operating systems was not significant at only 2.42% worldwide and 1.2% in China. Conventionally, these market shares would not give rise to competition concerns (which was also the conclusion by authorities in the US and the EU). However, MOFCOM's analysis focused on Microsoft's existing and Nokia's retained technology assets. The regulator raised foreclosure concerns based on the potential effect on incentives to license SEPs and certain non-SEPs to Chinese smartphone manufacturers. In particular, MOFCOM found that:

Microsoft's Android licensing programme.

Microsoft's Android licensing programme consists of a patent portfolio of primarily non-SEPs and a smaller number of SEPs licensed for use in smartphones operating Google's Android operating system (currently by far the most successful mobile operating system worldwide and in China, with a market share of 80% in the smartphone segment). MOFCOM held that, after acquiring the target business, Microsoft would have the ability and incentive to refuse to license, raise royalty rates or otherwise discriminate in licensing 26 indispensable non-SEP patent families for use in Android smartphones to foreclose competition with the target business in the downstream smartphone market in China.

Nokia's SEPs for mobile communications technology.

Nokia would retain an extensive portfolio of SEPs for 2G, 3G and 4G/LTE mobile communications standards used by all smartphone manufacturers. Since Nokia would no longer need to cross-license its portfolio of mobile communication SEPs for its Devices & Services Business-unit, it would have an incentive to increase royalties in the relevant patent licensing markets for communications technology SEPs to the detriment of smartphone manufacturers and end-consumers.

MOFCOM found that the transaction would be likely to have the effect of eliminating or restricting competition in the downstream smartphone market in China. On this basis, the agency required commitments from both Microsoft and Nokia to remedy its concerns, even though Nokia was not an undertaking to the transaction. More specifically, the commitments include:

Microsoft SEPs.

Microsoft commits for an indefinite period to continue licensing the SEPs on FRAND terms consistent with its undertakings to the relevant standard setting organisations ("**SSOs**") not to seek injunctions or exclusion orders against domestic Chinese smartphone manufacturers, and not to require licensees to license back any patents other than related SEPs.

Microsoft Non-SEPs.

As to the specified non-SEPs, Microsoft commits for a period of eight years to continue licensing the patents consistent with its existing licensing programmes, to cap the relevant royalty rates at their current level, and not to seek an injunction unless it determines (consistent with its current business practices) that a potential licensee is not negotiating in good faith.

Nokia SEPs.

Nokia also commits to honour its undertakings to SSOs to license on FRAND terms and to refrain from seeking injunctions against willing licensees (subject to reciprocity) or requiring licensees to also license Nokia's related non-SEPs. Nokia also commits not to depart from its generally offered RAND per unit running royalty rates unless justified by the factors currently assessed in setting those rates.

The competition concerns articulated in the decision appear to be linked to a novel theory of harm. The Taiwan Fair Trade Commission adopted a decision for this transaction, which also imposed licensing remedies on both Microsoft and Nokia, while the US Department of Justice and the European Commission cleared the deal unconditionally. The European Commission specifically found that there was no significant risk of vertical foreclosure and that the European merger regulations would not allow for remedies against Nokia because it is not formally an undertaking concerned (without prejudice to the Commission's power to review possible anti-competitive practices under Articles 101 and 102 of the Treaty on the Functioning of the European Union).

3.2 Google/Motorola Mobility

In May 2012, MOFCOM conditionally approved Google' acquisition of Motorola Mobility. Contrary to the unconditional clearance given by the counterparts in the EU and the US, MOFCOM required commitments from Google in favour of Chinese smartphone manufacturers. Specifically, Google undertook to keep the Android platform free and open and treat all smartphone manufacturers in a non-discriminatory way with respect to the Android platform.

Microsoft/Nokia and *Google/Motorola Mobility*, along with other decisions, underscore a broader regulatory policy in China focused on ensuring that domestic technology companies have access to IP which is vital to their operations. In both cases, MOFCOM highlighted the particular importance of the smartphone industry in China, which also reflects importance of a consultation with domestic and international smartphone industry participants in transactions in this sector.

4 Conclusion

Antitrust enforcement in the IP field is increasingly a hot topic in China. On the one hand, intensifying enforcement action suggests that IP-centred or related business models and practices will be under growing antitrust scrutiny going forward. On the other hand, market players currently do not have sufficient comfort due to the lack of clear guidance as to when their conduct would breach the AML.

Against this background, SAIC's recent IP Regulation is a welcome step towards clarity and predictability, but the regulation in many aspects still falls short of what the public have anticipated and also contains certain worrying provisions (e.g. the essential facilities doctrine). When designing business policies (e.g. setting prices for products or royalties of the licensed SEPs), companies should exercise extra caution by evaluating the potential risks under the AML. Separately, companies contemplating acquiring a target company for whom IP is a core asset, or setting up a joint venture into which the parent companies will contribute significant IP assets, are well advised to undertake thorough assessment in advance and be prepared for MOFCOM's readiness to pursue an independent path in assessing competition concerns and imposing remedies.

[1] Earlier abuse of dominance cases all related to domestic companies, namely Wuchang Salt (tying), local telecommunications companies (discrimination, margin squeeze), local pharmaceutical companies (refusal to supply). In addition local NDRC agencies probed local river-sand and pasteurised milk manufacturers for alleged excessive pricing.

[2] The Antitrust Guidelines for the Licensing of Intellectual Property issued by the Department of Justice and the Federal Trade Commission in the US; the Technology Transfer Block Exemption Regulation and the Guidelines on the application of Article 81 of the EC Treaty to technology transfer agreements issued by the European Commission.