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The Pro-competitive Value of Closed Platforms & Walled Gardens: Some Thoughts In Response to Tim Wu

Daniel M. Wall & Amanda P. Reeves[1]

I. INTRODUCTION

There has been a great deal of recent discussion, both inside and outside of antitrust circles, on the merits of "open" as opposed to "closed" business structures. Much of this discussion focuses on key technology markets, in which competition among products and systems that exhibit relative degrees of "openness" is commonplace and longstanding. An increasingly vocal group of openness advocates has begun to suggest that openness is an antitrust issue in its own right, and that antitrust regulators should adopt "openness" as a kind of social norm for the interaction of players in technology markets.

Timothy Wu's arrival at the Federal Trade Commission ("FTC") presents a good opportunity to discuss these issues, as he has been an outspoken critic of closed systems and what he perceives to be the failure of antitrust institutions to adequately police "information monopolists."[2] In his recent book *The Master Switch*, Wu argues that antitrust law has failed to protect consumers' interests when it comes to regulating competition in the computing and internet spheres.[3] Underlying his critique is his explicit and forcefully stated preference for open business models (his favorite example being Google) and his deep suspicion for closed systems (his favorite current example being Apple). Wu also argues that antitrust regulators should give greater weight to effects such as whether a particular merger or practice is likely to broaden public access to information. Wu believes that antitrust law has historically failed to facilitate the optimal information output and contends that it is time to consider whether antitrust law can do more to achieve these ends. He proposes a bold "Separations Principle," which would "mean that those who develop information, those who own the network infrastructure on which it travels, and those who control the tools or venues of access must be kept apart from one another."[4]

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[2] Transcript, *On the Media*, Interview with Tim Wu (Nov. 12, 2010), *available at* http://www.onthemedia.org/transcripts/2010/11/12/05.

[3] Timothy Wu, THE MASTER SWITCH 303 (2010) ("To leave the economy of information, and power over this commodity, subject solely to the traditional ad hoc ways of dealing with concentrations of industrial power—in other words, to antitrust law—is dangerous . . . I would argue that by their nature those particular laws alone are inadequate for the regulation of information industries.").

[4] *Id.* at 304.

In this Article, we address the antitrust treatment of open and closed systems, using Wu's proposals as a convenient (if hardly singular) reference point for the argument in favor of regulating towards openness. Our message is simple: antitrust law has dealt with the genuine competitive issues posed by closed systems adequately without any presumption or bias in favor of open systems. Antitrust's existing doctrinal mechanisms do a sufficient job not only of capturing anticompetitive conduct but also of promoting the innovation that follows from vigorous competition, which—particularly in technology markets—often takes the form of rivalry among closed systems. We fear that the inclination exemplified by Wu to inject antitrust's well-settled frameworks with subjective notions of what is "good" or "bad" would undermine pro-competitive behavior that in some sense is "closed," leading to more standardization and less differentiation. This is a price that antitrust regulators should not be willing to pay.

II. "CLOSED" PLATFORMS & THE IMPORTANCE OF SYSTEMS COMPETITION

Wu is a leading spokesman for a small, but vocal group that believes that competition policy could be improved by a recognition that open business models are inherently "good" (and presumably pro-competitive) and closed business models are presumptively "bad" (and therefore anticompetitive). Wu has adopted the starkly negative view that "[o]nce we replace the personal computer [a supposed epitome of openness] with a closed-platform device . . . we replace freedom, choice, and the free market with oppression, censorship, and monopoly."[5] He has taken aim generally at the iPhone and other Apple products, claiming that Apple's famously proprietary model means that Apple "machines are closed in a way the personal computer never was" and "all innovation and functionality are ultimately subject to Apple's veto."[6] Wu's views are similar to those espoused by Google, for which he has consulted. Google CEO Eric Schmidt has stated that "[i]n this global era our real enemies are inflexibility, proprietary systems and 'walled gardens' that let the elite in but leave the rest out."[7] Similarly, Harvard Professor Jonathan Zittrain has criticized Apple's move towards a closed platform noting that with the invention of the iPhone, "[t]he openness on which Apple had built its original empire ha[s] been completely reversed."[8]

Wu sees closed systems as a recurring antitrust problem and contends that there is a similarity between classic antitrust cases such as *AT&T*[9] and *Paramount Pictures*[10] and almost any contemporary example of a single firm controlling both information (or content) and the "network infrastructure on which it travels."[11] The latter concept of a network is extremely broad and encompasses devices like the iPod or iPhone that provide differentiated access to content. He then takes aim—somewhat ironically given his emphasis on classic antitrust cases—at antitrust's

[5] *Id.* at 293 (quoting Tom Conlon, "The iPad's Closed System: Sometimes I Hate Being Right," popsci.com (Jan. 29, 2010), *available at* http://www.popsci.com/gadgets/article/2010-01/ipad%E2%80%99s-closed-system-sometimes-i-hate-being-right).

[6] *Id.* at 304-06.

[7] Eric Schmidt, Editorial, *Technology: Only Closed Systems Can Hit Us*, FINANCIAL TIMES, Jan. 3, 2011, *available at* http://www.ft.com/cms/s/0/68350d0c-1773-11e0-badd-00144feabdc0.html#axzz1A5hHA0wZ.

[8] Jonathan Zittrain, Editorial, *A Fight over Freedom at Apple's Core*, FINANCIAL TIMES, Feb. 4, 2010, *available at* http://www.ft.com/cms/s/0/054bd53c-1147-11df-a6d6-00144feab49a.html.

[9] *United States v. AT&T Co.*, 553 F. Supp. 131 (D.D.C. 1982).

[10] *United States v. Paramount Pictures*, 334 U.S. 131 (1948).

[11] Wu, *supra* n. 3, 304.

alleged inadequacy to regulate vertical integration by so-called "information monopolists." He writes:

> To leave the economy of information, and power over this commodity, subject solely to the traditional ad hoc ways of dealing with concentrations of industrial power—in other words, to antitrust law—is dangerous. Without venturing into the long, rancorous debate over what, if any, kind of antitrust policy is proper in our system, I would argue that by their nature, those particular laws alone are inadequate for the regulation of information injuries.[12]

In lieu of antitrust rules, with their inconvenient limiting principles, Wu proposes his Separations Principle that amounts to a *per se* ban on vertical integration that links the creation and dissemination of information. This again is a strikingly broad proscription; for example, the recently approved Comcast-Universal merger "would simply be out of the question."[13] Wu acknowledges—and even makes a point—that his proposals go well beyond the current law. Yet he defends them because the social and economic costs of these "information monopolists" are too great to be checked by antitrust alone.

There is no doubt a certain intuitive allure to the notion that "open is good," and thus by contrast "closed" cannot be good. Yet whatever superficial sound bite appeal this position may have, we find it unsupported in logic, law, or mainstream economics. For starters, while critics are quick to laud open systems and criticize closed systems, what does it mean for a business structure or computing platform to be "open" or "closed"? Google and Apple—frequently cast as diametric opposites in this regard—prove the point. Google, which Wu fawns on as the paragon of openness, is at best "open" when and to the extent that it is profit-maximizing for it to make that choice. Where it makes its money, which is overwhelmingly from advertising tied to its publicly available search engine,[14] it is sometimes open and sometimes not. On the one hand, openness and a public web free of "walled gardens" advances certain aspects of Google's advertising business, because openness maximizes the number of consumers who use its dominant search engine, which creates the all-important eyeballs for advertisers. On the other hand, the mechanics behind Google's PageRank, AdWords, and AdSense products used for monetizing advertising revenue are tightly held "closed" secrets, as Google understandably does not want to share the value of its investments in these technologies. Most recently Google has been pilloried for refusing to open source the code for the Android 3.0 "Honeycomb" release, almost certainly because it is protecting select partners who are making tablet computers based on the code. None of these decisions are unusual or "evil," but they do reflect a selective regard for openness.

Along the same lines, Apple makes money by selling devices and operating systems.[15] As a result, Apple's devices and operating systems (much like Google's methods for monetizing ads) tend to be proprietary and, to a degree, closed. Yet to make those devices more attractive to consumers than competitor products, Apple needs to have distinctive content so, not surprisingly,

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[12] *Id.* at 303.

[13] *Id.* at 311.

[14] Google, Inc. 2009 Annual Report, filed Feb. 12, 2010 on SEC Form 10-K, at 37 ("Advertising revenues made up 99% of our revenues in 2007 and 97% of our revenues in 2008 and 2009.").

[15] Apple, Inc. 2010 Annual Report, filed Sep. 29, 2010 on SEC Form 10-K, at 33 ("Sales of devices and device-related products and services accounted for 93% of Apple's net sales in 2010, excluding standalone sales of operating systems.").

Apple has encouraged third parties to develop content. It has "opened" its platform to that extent. The costs of participating in the platform are by any measure exceedingly low, and the effect has been that over 100,000 third-party developers have created over 250,000 iPhone and iPad applications since Apple opened its App Store on July 11, 2008. The point is that Google and Apple are both "closed" to the extent that doing so allows them to monetize their proprietary information and they are both "open" to the extent that making their platforms public allows them to capitalize on their investments.

"Open" and "closed" also lack any generally accepted legal or economic meaning. Economists often use the term "closed" to describe vertically integrated systems, in which products are provided by one or a limited set of third-parties, rather than a system in which the provision of complementary products is open to all potential suppliers.[16] By that standard a policy norm against closed systems would be a frontal attack on the antitrust policy toward vertical integration, which, as its stands, is very tolerant to such integration. "Closed" can also mean proprietary, the opposite of open source, in which case a policy norm against closed systems is an attack on intellectual property rights more generally. As we understand it, Wu adopts a third view—namely, that closed systems result when a computing platform sponsor exercises any degree of control over the information or content that is carried on the platform. Apple's "curated" App Store, for example, is by this definition "closed" no matter how many apps are available or how few fail to gain Apple's approval. Clearly, if Wu or anyone proposes that the agencies use open and closed systems as proxies for what constitutes pro-competitive and anticompetitive conduct, far more work needs to be done to reach agreement on what these terms mean.

More importantly, the assertion that closed platforms are somehow harmful to consumers ignores the critical role that "closed" plays in systems competition. The mainstream industrial organization literature recognizes two broad levels of competition in the technology context: component competition (which is central to Wu's thesis) and systems competition (which is completely absent from his thesis). Component competition refers to the market dynamic whereby consumers purchase individual components and assemble them into systems. Components can include speakers, CDs, and satellite radio receivers used in stereo systems; nuts and bolts used in a mechanical system; or the film, lens, and other parts of a camera. Systems competition refers to the market dynamic that occurs when the focus of competition is on the price and non-price benefits of adopting one entire system—which economists define as "collections of two or more components together with an interface that allows the components to work together."[17] Systems are everywhere. A Lexus and a Mercedes have many of the same components (engines, transmissions, tires, etc.), but each car is unique and differentiated because different parts and collections of parts make up the final product. In the technology sector, the rivalry between Apple's iPhone and Google Android devices or between Microsoft's Xbox, Sony's Playstation 3, and Nintendo's Wii are examples of systems competition.

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[16] Joseph Farrell, Hunter K. Monroe, & Garth Saloner, *The Vertical Organization of Industry: Systems Competition versus Component Competition,* 7 J. ECON. & MANAG. STRAT. 143, 144 (1998) (referring to a "closed organization" as one in which "a single firm, or a small set of firms working hand in glove with one another, undertakes all those activities…", compared to an "open organization" in which many "firms compete in selling their individual components").

[17] Michael Katz & Carl Shapiro, *Systems Competition and Network Effects,* 8 J. ECON. PERS. 93 (1994).

A critical point is that a system must be "closed" to some extent to constitute a distinct system. That is, there has to be something different about a system, which others cannot replicate, for the collection of its components to qualify as a unique system. Gaming provides a good example, for whatever differences there may be among Microsoft, Sony, and Nintendo game consoles, the exclusive content that each platform offers (e.g., Halo on the Microsoft Xbox, Super Mario on the Nintendo Wii) and exclusive hardware such as the Xbox Kinect controller is much more differentiating. Full interoperability, or openness, is in tension with systems competition because the "mixing and matching" that it facilitates (such as using the Kinect on Sony's Playstation 3) destroys the competitive advantage of offering a differentiated system.

To have both component competition and systems competition, a competition policy regime must have rules that facilitate *both* open and closed platforms. It cannot choose one or the other, be it by direct rules (like a central planner) or by norms that disadvantage one type of competition. Component competition will have its place, most likely where the advantages of differentiated systems are minimal. But to have effective systems competition as well, the system or platform sponsors must have the ability to curate (or, as Wu and others would say, "close") its platform so that it can differentiate itself.

Wu is especially concerned with content restrictions, i.e., where the platform sponsor closes its network to information or information-rich products that it does not wish to carry. But what, a priori, is wrong with that? Differentiation may and often does result from a platform sponsor regulating the quality of content (such as only allowing software or applications that are free of bugs or offensive content) or from a platform sponsor requiring content developers to make "us or them" choices. There is no question that such policies *can* raise antitrust issues; access to Microsoft's dominant Windows platform was—on account of its dominance—a completely legitimate object of antitrust scrutiny and intervention. But such policies are not always an antitrust concern, nor presumptively a concern just because a "closure" affects content. It is not helpful to get preachy about the importance of information to our society. When Apple famously declared, "we have enough fart apps," the Republic was not threatened.

Systems competition increases consumer choice by providing consumers with more differentiated products and it drives innovation and differentiation at the broader systemic level.[18] We are better off in a world with PCs that offer differentiated components *and also* Macs and iPhones—and all the product improvements that the presence of this aggressive systems competition has inspired—than in a world of component competition alone. And if content restrictions have contributed to that diversity, it is something to be celebrated, not condemned.

Given the value of this competition, if the agencies are concerned about how a particular firm is behaving in the context of a closed platform, the agencies should refuse to infer (or even be predisposed to find) anticompetitive conduct from the mere presence of a closed platform. Such an inference standing on its own is a non sequitur. Rather, the better approach is for the agencies to ask the same basic questions essential to any standard monopolization analysis: Does

[18] *Id.* at 93, 108, 110 (noting that "the primary cost of standardization is the loss of variety: consumers have fewer differentiated products to pick from, especially if standardization prevents the development of promising but unique and incompatible new systems"); Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, 16 RAND. J. ECON. 70, 71 (1985) (counting "reduction in variety" as one of the "important social costs" of standardization).

the firm have monopoly power? Is it engaging in exclusionary conduct? Is the firm's conduct causing anticompetitive effects?

For one of us, Wu's effort to draw a parallel between the AT&T case and closed systems is particularly frustrating and misguided.[19] The monolithic Bell System was an extraordinary monopoly that controlled so many uncontestable bottlenecks that it was able to extinguish competition in numerous long distance services and equipment markets. It had proven immune to the kind of direct regulation (by the FCC and state public utility commissions) that is reserved for those industries in which antitrust proscriptions alone are deemed insufficient. The FCC's boldest efforts to restrict AT&T's monopoly power were abject failures. However, the predicates for an economically sound antitrust challenge existed: there was indisputable dominance on many levels; there were extremely high entry barriers; there were numerous examples of entry met by exclusionary conduct. And thus, without resort to simplistic views that content and carriage should not coexist in the same firm, the Bell System was broken up and competition flourished. This is not a parable for why we must throw away our principles and adopt arbitrary "Separations" rules. It is a crowning achievement of the antitrust system and its ability to deal with real competitive issues that concern closed systems.

Antitrust standards should not only be retained for these issues; they should be retained in their present form. We recognize that the FTC has expressed an increased interest in using its Section 5 "unfair method of competition" authority to reach conduct beyond the Sherman Act and that alternative theories of liability outside the Section 2 mold have been mentioned in connection with closed systems. That is just another way to water down our standards. When confronting antitrust issues raised by closed systems, we would caution both agencies that, whatever theory of liability they decide to pursue, liability should turn not on the "closed" or "open" nature of the platform, but on the rigorous antitrust analysis needed to confirm that a firm is using its market or monopoly power in a way that causes anticompetitive effects. The courts, if nothing else, will be bound by existing case law and will expect more.

III. THE ROLE FOR ANTITRUST IN INTERNET REGULATION

Wu has long been a champion for net neutrality and other proposals designed to "open" the internet. His concern is that the movement towards a closed internet—i.e., one where a user must download or purchase special software (in the form of an app) or join a closed community (in the form of a social network) to access information—will ultimately lead to all information and content being held by a few and not easily accessible by the masses. As noted earlier, Wu proposes a Separations Principle, which would "mean that those who develop information, those who own the network infrastructure on which it travels, and those who control the tools or venues of access must be kept apart from one another."[20]

In substance this is a rule banning vertical integration of content and carriage. However, there is no reason to believe that the agencies, Congress, or the courts would ever go so far as to declare whole categories of vertical integration *per se* illegal. Such an approach would, of course, fly in the face of decades of learning about the pro-competitive efficiencies of vertical integration. It would also undermine the Supreme Court's repeated statements in *Leegin* and other cases that "per se rules [are] confined to restraints, . . . that would always or almost always tend to restrict

[19] Daniel Wall was a member of the U.S. Department of Justice's trial team in *United States v. AT&T*.

[20] Wu, *supra* n.3, 304.

competition and decrease output . . . . To justify a per se prohibition a restraint must have manifestly anticompetitive effects" and "lack . . . any redeeming virtue."[21] Antitrust courts would also be singularly unmoved by the alleged social benefits of banning this kind of vertical integration, as non-economic policy goals simply do not belong in a proper antitrust analysis.

Wu's wholesale push for an open internet, however, does highlight why the agencies should be skeptical of claims that vertical integration and walled gardens are somehow harmful to consumers. Much of today's most popular web content (such as Facebook and Twitter) is in the social media context. These content providers offer products that depend on the consumer choosing to participate in a closed environment where (1) the consumer can control who has access to their personal information, and (2) the content developer can better shape the user's experience based on the increased access the consumer gives the developer to the consumer's information *precisely because the consumer is in a closed environment*.

The success and scale of these websites are a product of the fact that they have been able to leverage closed computing environments into a source of network effects: the more people that join Facebook or decide to Twitter, the more attractive it is for additional members to join these services. But this is up to a point, not endlessly. The marginal value of additional members can eventually be offset by the loss of demand-creating exclusivity, reduced security, or other factors. The app-based computing platform that now dominates smartphones and tablets has succeeded based on a similar closed model in the multi-sided market context: App Developers create products that attract consumers which, in turn, attract advertisers which, in turn, fund and fuel improvements to the apps. But since platforms compete on the basis of their app portfolios (witness Apple's "There's an app for that" ad campaign), it is beneficial to competition that there are differences in the app portfolios available on various platforms—differences that are fostered by policies that some deem "closed."

In this regard, the relatively short history of the web is filled with examples of how walled gardens have had pro-competitive effects by creating consumer demand for new products and more innovation and provoking competitive responses:

- Just four years ago in early 2007, MySpace was the dominant social networking site and it too was closed. Just as MySpace was a competitive reaction to early social networking websites like Friendster, Facebook emerged and sought to steal market share from MySpace by providing a better user experience.

- At the end of 2006, the smartphone market was dominated by the Palm Treo and Blackberry. The unveiling of the iPhone in 2007 and its dependency on apps as a means of providing a better user experience on its touchscreen mobile computing platform launched what is now a flourishing app market, to say nothing of how Apple's invention provoked a strong competitive response in the form of Google's Android Operating System (and the copycats that have followed).

- Tablet computers have been around for more than a decade and were originally brought to the market by Microsoft. Apple responded in 2010 with the iPad which created a

[21] *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 898 (2007) (internal citations and quotations omitted).

product that was so successful with consumers that it essentially reinvigorated the market and demand for tablet computing.

The point, metaphorically, is that an occasional walled garden is a welcome break from—and a great alternative to—open, untended fields. Walled gardens add to the diversity of the marketplace, not detract from it. The internet is more interesting and attractive because Facebook is on it. Mobile computing is vastly more interesting since the iPhone came along. And if being closed is part of what makes these sellers, their products, and their services special, as it often is, that is a good thing; it is not evidence of suspect competitive practices.

To be sure, as Wu insists, there are downsides to these walled gardens in the sense that the information they provide is not freely accessible to everyone. If you decide not to open a Facebook account, its content is essentially off limits to you. If you refuse to sign up for a Twitter feed, then an information source is not accessible to you. If you lack access to a smartphone or tablet or own one but refuse to select a particular app or platform, the information, games, and other content uniquely available through the app or platform will not be available to you.

The question on the table for the antitrust agencies, however, is when—if ever—this lack of universal access to information as a result of "closed" websites (or, in the net neutrality context, the ability of service providers to discriminate in how quickly content gets to you) rises to the level of an antitrust violation. Our answer: not often enough to justify the kind of ex ante proscription that Wu favors. Antitrust is generally better suited to the *ex post*, case-by-case approach associated with the rule of reason (which we advocate for here) than the *ex ante*, categorical approach associated with *per se* illegality and regulation (as Wu and others have proposed). Thus, if one is looking for antitrust law to provide a means to support more regulation of the internet, it is likely to be most useful insofar as one could potentially demonstrate in a specific case that vertical integration between last-mile broadband providers and content suppliers would allow those providers to have anticompetitive effects. In that case-specific analysis, the core principles of antitrust can be applied to the facts, and the potential for over-deterrence that any *ex ante* proscription carries can be minimized.

Beyond these case-specific applications, however, we believe the antitrust agencies' most important role is to advocate vigorously for all policymakers to properly weigh fundamental principles of competition law in any effort to regulate the internet—be it a statute, an FCC rule, or a federal judicial decision. Whatever the virtues of the "open web," and clearly there are many, the role of antitrust policy is to let markets decide what is "good" or "bad." From an antitrust perspective, the agencies do well to point out that simply asking whether the "open web" is in any absolute sense "good" or "bad" poses a wrong and dangerous question. The question that matters is whether the conduct, merger, rule, or statute at issue is likely to inhibit or promote a competitive process that in its own way answers these questions. This is an important message that should be voiced affirmatively. Given the critical role that competition has played (and continues to play) in fostering innovation, including innovation in business models, the option for antitrust regulators to simply stay on the sidelines as non-antitrust policymakers make *ex ante* rules that could disrupt this aggressive competitive environment is too risky.

IV. CONCLUSION

With the centrality of computers and the internet as information sources, the challenge for antitrust policymakers is to properly identify when market intervention is appropriate. If they wait too long, the market tips and restoring competition may be all but impossible. If they

intervene too early, they can do unknowable harm to the market's invisible hand. Where we ultimately depart from Wu is in simplistically assuming that "open" is good and "closed" is not, and on the question of whether non-traditional antitrust objectives—such as the seemingly laudable goal of promoting public access to information—should affect this calculus. In our view, both "open" and "closed" business models are good things—we would like more of both. And insisting that regulators use antitrust law to promote objectives other than competition and innovation runs the risk of too much intervention at too great a cost. "Closed platforms" and "walled gardens" may, superficially, sound troubling, but unless and until it can be shown that their evolution has had anticompetitive effects, and that those effects outweigh their pro-competitive value, we see no reason to use antitrust law or some quasi-antitrust policy as a way to chart their demise.