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China Issues Final IP / Antitrust Rules

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Antitrust & Competition Law

Following several years of drafting and public consultations, on April 13 the State Administration for Industry and Commerce of the People's Republic of China ("SAIC") released its *Rules on the Prohibition of Abuses of Intellectual Property Rights for the Purposes of Eliminating or Restricting Competition* (the "Rules"). The SAIC is one of three agencies responsible for enforcing China's Anti-Monopoly Law ("AML"). The Rules, which will take effect on August 1, 2015, are expected to guide the agency's future enforcement actions in this important area of AML enforcement.

Summary

The Rules apply to agreements regarding intellectual property rights ("IPRs"), other coordinated activity (including patent pools and standard-setting and implementation), and certain unilateral conduct by dominant firms and are intended to "protect fair market competition and encourage innovation" by "prohibit[ing] the abuse of intellectual property rights by undertakings to eliminate or restrict competition." They could have a significant impact on the licensing of intellectual property in China, particularly by firms that account for a large share of sales in either a relevant product or technology market or hold patents that are essential to an industry standard.

For example, the Rules:

- Prohibit "dominant" IP holders from refusing "without justifiable reasons" to license their IP under reasonable conditions when the technology is "essential for companies to compete in the relevant market," or from engaging in certain types of exclusive dealing (including requiring exclusive grant backs), tying, discrimination among similarly situated licensees, and other specified "unreasonable" conduct;
- Prohibit certain conduct by participants in patent pools; and
- Regulate the activities of IP holders in the context of standards-setting and standards-implementation, among other things requiring that holders of "standard-essential" patents ("SEPs") license their SEPs in a manner consistent with the "fair, reasonable, and non-discriminatory" ("FRAND") principle.

The Rules also create a narrow and qualified "safe harbor" for certain horizontal agreements among competitors and vertical agreements between trading parties, and generally describe a rule of reason-type approach for evaluating whether particular IP licensing conduct may violate the AML.

Because SAIC only has AML enforcement authority over conduct that is not related either to pricing or to mergers and other transactions—the latter two areas being under the jurisdiction of the National Development & Reform Commission ("NDRC") and Ministry of Commerce ("MOFCOM"), respectively—the Rules do not address issues such as the charging of royalties that are “unfairly high,” which was the focus of NDRC’s recent investigation of QUALCOMM, Inc. Also, although the Rules will guide SAIC matters involving IP and competition, neither MOFCOM nor NDRC is required to follow them. Whether MOFCOM or NDRC will, in practice, look to the Rules when conducting their own investigations is not clear.

The Rules are discussed in greater detail below.

Relevant Market(s) & “Dominance”

In addition to excluding “price monopolistic conduct” from the scope of the Rules, Article 3 states that the agency will in general follow the provisions of the AML and of the Chinese State Council’s *Guidelines on the Definition of Relevant Markets* when defining relevant markets within which to assess the legality of IP-related conduct under the AML. Importantly, Article 3 also notes that a relevant product market “may either be the technology market or a product market” comprising of products that incorporate the technology. A “relevant technology market” is described as the market that includes “the technology involved in the exercise of the intellectual property rights and other substitutable technologies of the same type.”

The Rules clarify that a holder of IP will not necessarily be deemed “dominant” simply by virtue of its patent. However, the market share-based dominance thresholds of the AML are relatively low. The Rules establish a rebuttable presumption of dominance for a company that (i) has a 50 percent or greater share of the relevant technology or product market; (ii) together with one other company has a 66 percent or greater share of the market; or (iii) together with two other companies has a 75 percent or greater share of the relevant market.

“Safe Harbors”

Articles 13 and 14 of the AML list specific types of horizontal and vertical agreements, many of them related to pricing and thus outside the scope of the SAIC Rules, that are prohibited as anti-competitive “monopolistic agreements.” Both Articles also contain “catch-all” provisions prohibiting “other monopoly agreements” – Articles 13(6) and 14(3), specifically. Article 5 of the SAIC Rules provides that an agreement will *not* be considered a monopoly agreement under these catch-all provisions if:

- the parties to a horizontal agreement have a combined market share of no more than 20 percent of the relevant market or there are “at least four other substitutable, independently-controlled technologies that can be obtained at reasonable cost in the relevant market”; or
- neither party to a vertical agreement has a market share greater than 30 percent, or there are “at least two other substitutable, independently controlled technologies that can be obtained at reasonable cost in the relevant market.”

Article 15 further clarifies that if the parties to an agreement were not competitors at the time of entering the agreement, but only became competitors after entering into the agreement, their agreement will not be considered a horizontal “agreement between competitors.”

The Rules represent the first time that an AML enforcement agency has provided a safe harbor provision and are thus a positive step forward. However, it bears noting that these harbors are relatively small and do not apply to the agreements specified in Articles 13(1)-(5) and 14 (1)-(2), such as market allocation agreements or vertical resale price maintenance agreements. Furthermore, even IPR holders that qualify for “safe harbor” treatment may still find themselves under investigation, and possibly the subject of an enforcement action, if "evidence to the contrary proves that [their] agreements have the effect of eliminating or restricting competition."

Refusals to License "Essential Facilities"

Article 7 states that a unilateral refusal to license will violate the AML if the IPR holder is "dominant" (see above), if the refusal to license "eliminate[s] or restrict[s] competition," and if the technology in question is "essential for production and business operations." Article 7 provides the following factors that SAIC will consider when evaluating a refusal to license:

- Whether a "reasonable substitute" for the IP is available and whether the IP is "essential companies to compete in the relevant market";
- Whether the refusal to license will "have an adverse impact on competition or innovation in the relevant market," to the detriment of "the interests of consumers or the public interest"; and
- Whether licensing the IPR will cause unreasonable harm to the IP holder.

In an improvement from the last draft of the Rules, which provided that IPRs could be considered an "essential facility," and thus potentially subject to compulsory licensing, if any of these factors was present, the final version of the Rules suggests that a finding of essentiality will be made only if all three factors are satisfied.

This provision was the subject of intense discussion and criticism during the drafting and public comment stages of the Rules' development. The "essential facilities" doctrine has never been endorsed by the U.S. Supreme Court and has rarely been used even in those jurisdictions where it exists. More significantly, as the American Bar Association noted in the comments it submitted to SAIC, the doctrine has never been used in the context of patent licensing anywhere in the world. That may change as a result of the Rules and, depending on how Article 7 is enforced, companies that hold valuable IP and that operate in China may increasingly become subject to AML investigations and enforcement actions by SAIC for refusals to license their IP.

Prohibited Conduct by Dominant Firms

Article 10 prohibits a dominant firm from imposing the following "unreasonably restrictive" terms when exercising its IPR, absent having a justifiable reason for doing so:

- requiring a counterparty to grant back to the firm an exclusive license to technology improvements made by the counterparty;
- prohibiting a counterparty from challenging the validity of the dominant firm's IPR;
- restricting a counterparty from using competing goods or technologies after the expiration of the license agreements, when such use does not infringe the dominant licensor's IPR;
- continuing to exercise its IPR after the protection period for such IPR has expired or such IPR has been determined to be invalid;
- prohibiting a counterparty from trading with any third party; or
- attaching other restrictive conditions that the agency may determine to be unreasonable.

The references to “reasonableness” and “justifiable reasons” suggest that SAIC will apply a rule of reason-type analysis to its review of IP licensing under the Rules. However, the extent to which the agency will base its enforcement on economic analysis of competitive effects remains uncertain.

Patent Pools

Article 12 prohibits certain conduct by participants in “patent pools,” which the Rules define as an agreement-based arrangement where two or more patent holders jointly license their patents to third parties, often under the direction of a patent pool management organization. Article 12 specifically prohibits members of patent pools from exchanging competitively sensitive information for the purpose of facilitating monopoly agreements. It also prohibits the pool or its management organization from engaging in the following activities, if the pool collectively has a dominant market position and if the conduct “eliminates or restricts competition”:

- restricting members of the patent pool from independently licensing their patents;
- restricting members or licensees from researching and developing technologies that compete with the pooled patents;
- forcing licensees to grant back on an exclusive basis to the patent pool management organization or a member of the patent pool any technologies that licensees have developed or improved;
- prohibiting licensees from challenging the validity or effectiveness of the pooled patents;
- treating pool members or licensees differently with respect to licensing terms than similarly-situated pool members or licensees that operate in the same relevant market;
- engaging in other conduct that the SAIC may determine to be abusive.

Patent pool participants should use care in structuring their arrangements to avoid conflicting with these provisions. Where pool members are required to share information on licensing, sales, or market share to determine respective royalty distributions, it may be preferable to provide that information only to the management organization and not further disseminate it to other members, to avoid raising the risk of the appearance of facilitating an unlawful monopoly agreement. Companies that participate in patent pools—whether in China or elsewhere (the Rules do not clearly state that they apply only to patent pools in China)—might also consider auditing their pools’ licensing practices to determine whether they may raise issues under any of the specific categories of prohibited conduct described in the Rules.

Standard-Essential Patents

Finally, Article 13 provides that companies must not use the setting or implementation of standards to engage in conduct that eliminates or restricts competition. Specifically, a dominant firm must not, without justifiable reasons:

- deliberately fail to disclose patents when participating in the standard-setting process, or explicitly waive patent rights during that process but later assert those rights against implementers of the standard after it has been adopted; or
- after its patents have become SEPs, refuse to license them on FRAND terms, engage in tying, or impose other unreasonable conditions that eliminate or restrict competition.

Article 13 appears to apply to conduct regarding any standard or standard-setting organization ("SSO"), regardless of whether that SSO promulgates its own policy for IPR disclosures and FRAND commitments. Also, the second of the two provisions, regarding refusals to license on FRAND terms or engaging in other "unreasonable" conduct after a standard has been adopted, is not clearly limited to companies that participated in the setting of the standard in question.

Read together, these rules could be interpreted by SAIC to apply to the licensing practices of *any* holder of SEP, regardless of whether it made a commitment to license its patents on FRAND terms and regardless of whether the SEP holder participated in the SSO in the first place. Such an approach would be a departure from that taken by the competition law enforcers of jurisdictions such as the US and EU, which encourage the adoption of FRAND policies by SSOs but which stress that participation in standard-setting should be voluntary and that patent holders should be free to exclude some or all of their technology from the standard-setting process.

Covington is well positioned to assist companies regarding their operations in China. If you have any questions concerning the material discussed in this client alert, please contact the following members of our firm:

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