Department of Justice

ANTITRUST IN AN ERA OF HIGH-TECH INNOVATION

Address by

JOHN M. NANNES
Deputy Assistant Attorney General
Antitrust Division
U.S. Department of Justice

National Institute on
Representing High Technology Companies
Sponsored by the
American Bar Association
Business Law, Litigation, Tort and Insurance Practice Sections
and the Center for Continuing Legal Education

Boston, MA

October 22, 1998

ANTITRUST IN AN ERA OF HIGH-TECH INNOVATION

Thank you for inviting me to participate in your conference today. I can well understand why current developments in antitrust are of interest to those of you who represent high-technology companies, and I look forward to sharing some of those developments with you.

I. Antitrust Overview

Three weeks ago, the government closed the books on fiscal year 1998. The year was a notable one for the Justice Department's Antitrust Division in a number of respects. We collected more than $267 million in criminal fines, substantially exceeding the record level of fines established one year ago. Notably, more than 90 percent of the fines were imposed in criminal cases involving international cartel behavior, and roughly 50 percent of corporate defendants were foreign-based, a substantial change from a decade ago when many of our criminal cases involved localized conspiracies with modest effects on commerce. Probably the most widely-followed criminal trial during the year was, of course, the <u>ADM</u> case, which resulted last month in jury verdicts convicting all defendants. That level of enforcement is likely to continue over into the current fiscal year. We have about 100 open grand jury investigations, more than two dozen of which are looking into suspected international cartel behavior.

The pace of mergers and acquisitions reached an all-time high level. Once again, =HSR filings eclipsed a record that had been established in the preceding year. There were over 4,600 HSR filings during the fiscal year, an increase of 25 percent. The recent downturn in the stock market seems to have affected the pace of such transactions; comparing September 1998 with September 1997 data reveals an increase, but at a lesser rate than year-on-year comparisons for earlier months. This fiscal year, we challenged 51 transactions, the most notable of which were probably Lockheed Martin's proposed $11.6 billion acquisition of Northrop-Grumman, which was abandoned by the parties after substantial discovery but before trial, and the proposed acquisition by Primestar Partners, a consortium of major cable TV companies and others, of a satellite slot to provide high-power DBS service, which was scheduled to go to trial in February 1999 until the parties announced last week that they were abandoning it.

We also had an active civil non-merger enforcement program, settling a number of cases to establish important principles in such diverse areas as joint marketing agreements, intellectual property licensing, tying agreements, non-compete agreements, and most-favored nations clauses. But, of course, as we all know, fiscal year 1998 will certainly go down in antitrust history as the year of the Microsoft case.

II. Antitrust and Innovation

Your program today, devoted to antitrust in high-technology industries, could not be more timely. Just three days ago, trial in the Department's case against Microsoft began in Washington. Not surprisingly, the Microsoft case has become a focal point of public and media attention, perhaps unlike any antitrust case in our lifetime, with the possible exception of AT&T, and it will directly address the relationship between competition and innovation. But my thesis today is that the Microsoft case is not unique; instead, it is simply an example of the way in which antitrust analysis has evolved -- and will continue to do so -- to meet and address changes in the marketplace that have profound competitive implications for producers and consumers.

The Microsoft case has provoked many observers of the antitrust scene to inquire whether the antitrust laws are adequate to meet the challenges of today's marketplace. To be sure, the antitrust laws were passed and initially applied to what are now commonly called "smokestack" industries. Yet, Congress chose a flexible statutory standard, based upon the common law, to form the contours of our antitrust jurisprudence. Thus, even during the era of challenges to "smokestack" industries, courts developed standards that allowed for dynamic, rather than static, antitrust analysis and encouraged, if not mandated, that care and attention be given to market conditions in order to apply the antitrust laws properly.

Thus, there was already in place a flexible antitrust framework for application to the competitive challenges presented by the new computer era. To be sure, the particular circumstances of this era demand sensitivity to the facts and circumstances that make it unique. A market consisting of intangible ideas can change more quickly than a market consisting of tangible assets. Some commentators have suggested that this factor points in a single direction: the possibility of radical new ideas that can transform the marketplace overnight provides a built-in remedy for anticompetitive behavior, thus diminishing the role that the antitrust laws might otherwise constructively play. Other commentators have recognized, however, that this phenomenon may also operate in the other direction: especially in network industries, first-mover advantages and other market characteristics may call for accelerated assessment of antitrust consequences, lest the proverbial horse get out of the barn. These phenomena, not unique to computer-related industries, have reinforced the realization that antitrust must be a forward-looking, rather than a backward-looking, enforcement regime. That principle is demonstrated in a wide variety of antitrust enforcement actions that the Department brought during the recently concluded fiscal year that focused on innovation effects.

There certainly was a time -- and it would not overstate matters too much to say that it continued until relatively recently -- when the sole focus of antitrust inquiry was upon price and output effects. Indeed, it was common to define market power in terms of the ability to raise price above the competitive level or decrease output below the competitive level. In at least two merger challenges brought by the Department in the past year, however, a critical element in the Department's decision to challenge the transaction was the potential impact upon innovation.

Last March, the Department filed a Section 7 action to enjoin Lockheed-Martin's proposed $11.6 billion acquisition of Northrop-Grumman. This action, which was brought by the Department with the cooperation and support of the Defense Department, represented the largest acquisition ever challenged in the history of federal antitrust enforcement. The complaint alleged that the acquisition would have tended substantially to lessen competition in numerous separate product markets -- some of which would have been reduced to one or two suppliers -- with substantial price effects. However, a cornerstone of the Department's antitrust challenge was concern that the acquisition would have substantially lessened competition with respect to innovation in the development of various products and services for defense applications.

Unlike the challenge that sometimes faces us in other cases, it was very easy to articulate the ways in which a decline in innovation could have an adverse effect. As the Attorney General indicated when the case was filed, reduction in the pace of innovation could literally have life-and-death implications for our servicemen and women. The products implicated by the transaction were on the cutting edge of high technology: high performance military aircraft, infrared and radio frequency electronic warfare countermeasures, airborne early-radar systems, fire control radar, and sonar combat systems.

In these markets, much of our concern was about the impact that the transaction would have on innovation and product development. As you know, our national defense strategy depends on maintaining a substantial technological lead over possible adversaries. We found support, not only in economic literature, but also in studies of military markets, for the proposition that competition is important for major technological advances. During the course of our investigation, we discovered instances in which major advances in technology had come from sources other than the dominant incumbent provider of the particular military system or subsystem at issue. In the defense business, pathbreaking technological breakthroughs have often been made, not by the dominant supplier of military systems, but by niche players or leading firms working outside their main areas of specialization. This was the case, for example, with respect to high performance military aircraft.

We ultimately concluded that one competitor was not enough and that even in markets characterized by lumpy purchases and high research-and-development expenditures, two competitors were not necessarily sufficient to assure the kinds of innovation that only an open and robustly competitive market structure was likely to generate.

As you know, in the face of our challenge -- after considerable discovery and the type of procedural skirmishing that comes with a case of this size -- the parties abandoned the transaction. Lockheed-Martin and Northrop-Grumman have expressed the intention to compete aggressively for military procurement contracts. Especially at a time of heightened tensions in various locations around the globe, the Department believes that the military directly -- and all of our citizens indirectly -- will benefit from this competition with respect to innovation, as well as price.

In a much less-celebrated antitrust action, brought only last month, the Department required Halliburton and Dresser to divest Halliburton's logging-while drilling ("LWD") business as a condition of closing their transaction. The consent decree between the parties has been submitted to the District Court in Washington for consideration, so I would like to offer some observations about the case that are taken directly from the complaint itself and the competitive impact statement.

LWD services are important in the exploration for oil and gas because they allow the producer to obtain data from the well-bore without interrupting the drilling process. Particularly in off-shore drilling applications, where daily rig rental costs are substantial, the ability to obtain down-hole information in this manner is important for cost-efficient exploration.

We found that there were four major providers of LWD services, including Halliburton and Dresser, but that for some LWD services there were also a number of fringe players, whom the parties contended could constrain the pricing discretion of the majors, even in a post Halliburton-Dresser world. Our investigation revealed, however, that customers believed that important innovations in LWD services had come solely from the majors; fringe players tended to play follow-the-leader, offering last-generation products that had already been superseded by the next generation of innovations. Concerns were expressed about the effects of the proposed transaction on innovation. Indeed, insofar as we could tell, a number of customers were more concerned about innovation effects than price effects. Thus, the relief that we sought, which the parties agreed to provide, included divestiture not only of existing manufacturing and marketing operations, but also research-and-development facilities.

The Department's concerns about innovation are by no means limited to mergers and acquisitions. Just two weeks ago, the Department filed a Section 1 action against Visa and MasterCard, alleging that the overlapping ownership and governance of these two associations by the same major banks had anticompetitive effects, particularly with respect to innovation at the credit card network level. Visa and MasterCard have suggested that there can be no competitive problem: After all, households are deluged with solicitations from banks seeking to issue credit cards. Isn't the credit card industry fully, if not excessively, competitive?

The answer lies in the distinction between the upstream network market and the downstream issuer market. It may be that there is substantial competition at the issuer level, with various banks setting their own terms and conditions regarding annual fees and interest rates. Such competition at the issuer level, however, is no substitute for the important competition that should take place at the network level with respect to product and service enhancements that cannot realistically be undertaken at the issuer level, but are nonetheless extraordinarily important to consumers.

The complaint alleges that the overlapping ownership and governance structure of Visa and MasterCard provides a disincentive for the banks that own and govern the two associations to finance innovations that could have shifted market share from one association to the other. In this regard, the complaint alleges, for example, that development of so-called "smart cards" was delayed for up to a decade because overlaps between Visa and MasterCard prevented either association from proceeding with innovation independently. Smart cards can store information on an integrated circuit that is capable of storing significantly more information than magnetic stripes. This additional data storage capacity would enable a card network to enhance its products by, among other things, storing cash and personal information such as airline and hotel preferences, identification numbers, and medical data. Many people believe that there would be substantial consumer interest in such card products.

This case is obviously at a very preliminary stage, although the judge has indicated an intention to move it along very quickly, and the Department expects that this will be a contested litigation. My point in recounting it to you is a limited but important one. The Visa and MasterCard case is certainly one of the most significant Section 1 cases brought by the Department in years, yet it is based predominantly upon concerns about innovation effects, rather than price effects. It should be evident to the antitrust world that the Department now considers innovation effects every bit as much as price effects in determining the antitrust consequences of particular business conduct.

The fact the Department now regularly finds itself looking at innovation implications of business behavior by no means suggests that such inquiries are easy to undertake. Indeed, the opposite is probably true. While sophisticated econometric tools and analytical constructs may be available to assist in predicting price effects on the basis of various structural characteristics, the road map for identifying and assessing innovation effects is less developed. While history, as expressed through market share, will often be an important proxy for predictions of future behavior with respect to price effects, we do not approach innovation effects with a presumption that the past is necessarily prologue. We are, in these circumstances, forced to make very difficult predictive judgments guided, to be sure, by the basic policy underlying the Sherman Act: that competition will yield the best economic results for our society. While that task is sometimes not an easy one, the alternative is abdication of our responsibility to carry out the tasks mandated by Congress through its enactment of the antitrust laws.

III. Antitrust Personnel

Finally, I thought those of you who have occasion to practice frequently at the Department might be interested in some personnel developments that have occurred at the Antitrust Division during the past fiscal year. In the front office, Larry Fullerton and Charles Biggio left to resume careers in private practice. Assistant Attorney General Joel Klein took this opportunity to reorganize the front office on the civil side at the deputy level. Donna Patterson, assisted by Susan Davies, is the merger deputy. Doug Melamed continues to work with the Appellate, Foreign Commerce, and Telecommunications Sections, in addition to his Microsoft work, and I work with the Civil Task Force, Computers and Finance, and Transportation, Energy and Agriculture Sections. Of course, Gary Spratling continues as the deputy for criminal matters.

At the director level, which is the principal repository of the Department's institutional wisdom, the Department continues to rely on Becky Dick (civil non-merger), John Orr (criminal), and Connie Robinson (merger). In addition, Joel Klein recently established a director position for our Economic Analysis Group and convinced Marius Schwartz to return to the Department and assume that responsibility to assist deputy Dan Rubinfeld.

The Department has long benefited from an outstanding career staff. The excellence of our staff was driven home again recently when Tony Nanni, chief of our Litigation I section, received the Presidential Rank Award of Distinguished Executive, the highest award given to career civil servants in the senior executive service. This award is obviously a terrific personal accomplishment for Tony, but it also reflects well on all our colleagues at the Antitrust

Division.

IV. Conclusion

I know you have a full agenda for the afternoon session of your program. In particular, I note that you have an outstanding panel of antitrust experts to discuss the implications of antitrust in a high-tech world. Thank you for letting me spend these few moments with you to "tee-up" the afternoon's program.

Big Tech and antitrust: Pay attention to the math behind the curtain. Tom Wheeler. Friday, July 31, 2020.Â Risk management rather than micromanagement: rigid industrial era utility-style regulation is incompatible with todayâ€™s rapid pace of technological change. Regulation should be based on risk-targeted remedies focused on market outcomes. Restoration of common law principles: for hundreds of years common law has required those providing services to anticipate and mitigate harmful effects (a â€œduty of careâ€), as well as providing access to essential services (a â€œduty to dealâ€).Â Gene Kimmelman served in antitrust positions in both the Congress and Department of Justice. Related Topics. Regulatory Policy. Technology & Innovation. Telecommunications & Internet. Antitrust, therefore, can still play an essential role in order to prevent abuses of market power. Healthy competition, after all, spurs further innovation. Therefore, assuming that there is a role for antitrust in the information economy, the characteristics of high-tech markets still require that antitrust laws be applied cautiously, informed by the facts of the specific situation. It is important that antitrust authorities know when to intervene and when to forbear; it may be extremely difficult to judge when a market will be sufficiently 'innovation-intensive' to justify noninter For decades, tech giants have swallowed up startups with minimal government interference. This weekâ€™s antitrust hearings suggest that could change.Â Congress just signaled that the era of Big Tech acquisitions is over. For decades, tech giants have swallowed up startups with minimal government interference. This weekâ€™s antitrust hearings suggest that could change. high-tech sector.48 And Enforcers have voiced reservations about drastic measures like "breaking up big tech" and utility regulation.49. Nonetheless, the antitrust authorities do seem to be more interested in the high-tech space and particularly platform competition and are investing additional resources to assess such competition issues. This increased interest may already be leading to more investigations, and if the antitrust agencies are concerned about competition in particular markets, they may be more inclined to dig deeper and investigate longer in these market segments.