Thoughts on systems competition

Hanno F. Kaiser

Latham & Watkins LLP
UC Berkeley, Boalt Hall School of Law

Contact information:
hanno.kaiser@lw.com
P: 415.395.8856
Home: www.hannokaiser.com

Systems raise common tying, foreclose, and efficiency issues

"Collection of two or more components together with an interface that allows the components to work together." (Katz & Shapiro)	**Efficiencies, reduced transaction costs (analogous to the theory of the firm)**
	Tying, monopolization
Anything that creates and maintains a boundary and thus an inside/outside dichotomy (Luhmann, Varela)	**Foreclosure**

Most systems are open in some respects and closed in others

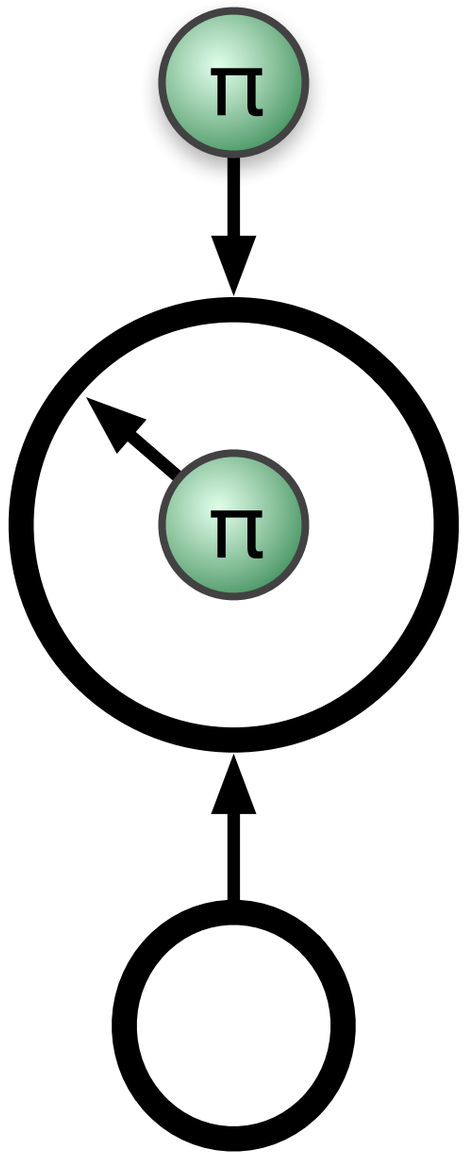
- Open, standards-based systems (e.g., TCP/IP, Linux, OSS) raise no risk of foreclosure or tying
  - Stronger justification for open systems preference at the infrastructure layer than at the application layer (modifying property defaults)?
- Closed systems may provide stronger innovation incentives for certain products
  - Reduce complexity and stabilize the development environment. Potential for more reliable products (e.g., Sega Genesis, XBOX, “closed loop” car maintenance)
  - Allow for more diverse monetization models
  - Allow for resource focus and faster development (e.g., console v. PC game development)

Taxonomy of systems competition cases and key normative considerations

External component cases (e.g., Memorex)

Intrasystem cases (e.g., Kodak)

Intersystem cases (e.g., MCI, Trinko, MSFT)



- Intrasystem: “To what extent does the platform creator own derivative component markets?”
- External component: “To what extent may the platform provider close a previously open system, appropriating benefits co-created by outsiders?”
- Intersystem: “Should dominant systems be permitted to remain airtight?” (essential facility)
  - Preference for systems-only or “systems plus component competition?”
  - Preference for incremental v. radical innovation?
  - Preference for investment in market expansion v. free riding?

Systems competition in practice: defensive and offensive uses

- Defense
  - In aftermarket cases, defendants often claim that foremarket (i.e., systems) competition constrains their ability to monopolize component markets (lock in exploitation, quality control, price discrimination)
- Offense
  - Where there is no stand-alone concern in component markets, plaintiffs may claim effects in a more highly concentrated systems market
  - Where two-sided platforms are active in the same space and compete for users on the “free” side, there often is no competition for participants on the “pay” side. Lacking a clear theory of harm, plaintiffs may find it tempting to resort to a more general claim of preserving “systems competition” or “platform rivalry.”

Easy labels still don’t provide ready answers

- The systems label is useful to describe boundaries around components created by combination, contract, IP, and technology
- Normatively, however, nothing definitive follows from the label, other than an indication of the likely “legal neighborhood” (tying, monopolization, RPA)
  - “Systems competition” should be more than a shorthand for a normative preference for deconcentration and preservation of rivalry
- Empirical evidence of actual competition is still indispensable
  - Systems too have sales and marketing departments, discount approval forms, strategic planning sessions, price cuts, and R&D programs. Those realities, not abstract concepts, should guide the antitrust analysis.

The real stress test for the antitrust laws are ecosystem industries

- Many interactions between multi-sided platforms are so complex and non-linear that even the participants often lack the ability to predict outcomes (e.g., Google/DCLK, Yahoo/Google; TradeComet/Google)
  - Vast collections of data have thus become a substitute for theory. Instead of creating models about the future, firms accelerate experimentation, observation, and incremental adjustment (rapid evolution).
- Antitrust law, however, relies on predictions for all ex ante cases – how can the complexity be reduced?
  - Shift the focus to ex post cases?
  - Rules of thumb for “platform diversity”?
  - “Open systems” presumption of legality?
  - “Rapid success without market power” presumption for legality even for closed systems?