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Some practical and competition concerns with the proposed Regulation on Standard Essential Patents

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The European Commission on 27th April presented a proposal for a regulation on standard essential patents (SEPs) (Draft SEP Regulation).¹ SEPs are those patented inventions needed to comply with a standard. If adopted, the SEP Regulation will radically change the current SEP licensing ecosystem, which was formed gradually with broad global industry consensus over the last 30 years. In brief, amongst others the SEP Regulation: i) requires the registration of all SEPs in force in EU Member States before the newly established Competence Centre at the EU Intellectual Property Office (EUIPO), as a pre-condition for litigation of SEPs in the EU; ii) provides for annual essentiality checks of registered SEPs; iii) introduces a system of notification of aggregate royalty rates for standards, and iv) requires entering into mandatory FRAND determinations before initiating SEP litigation in the EU.

The aim of this short paper is to highlight some practical and competition concerns surrounding certain proposed measures of the Draft SEP Regulation addressing perceived problems. There are many aspects that could be criticised. In particular, the lack of evidence of a market failure justifying regulatory intervention, the overall unbalanced nature of the provisions, the harmful impact on innovation of European companies, and geopolitical spill-overs which could lead to the fragmentation of the global standardisation ecosystem. This paper focuses on a few practical issues that are salient within the Draft SEP Regulation.

1. Who will pay for the costs?

The first questions that comes to mind is who will pay for the new system? According to the Impact Assessment, SEP owners will bear all the costs while implementers will reap all the benefits.² The ten-year average approximate annual benefits for SEP implementers are estimated at €24.4 million, while for SEP owners the costs are estimated at €28.9 million. As such, the Draft SEP Regulation directly seeks to redistribute value from SEP owners to implementers. It is difficult to see from the Commission's Impact Assessment, why such value-redistribution is necessary and justified.

¹ Commission, Proposal for a Regulation of the European Parliament and of the Council on Standard Essential Patents and Amending Regulation (EU) 2017/1001, COM(2023) 232 final (SEP Regulation).

² Commission, Impact Assessment Report Accompanying the Document Proposal for a Regulation of the European Parliament and of the Council on Standard Essential Patents and Amending Regulation (EU) 2017/1001, SWD(2023) 124 final (Impact Assessment), p. 58.

The new system could potentially benefit SEP owners if it were to lead to smoother licensing agreements and prevent holdout by standard implementers.³ However, the Commission noted that the effects of the Regulation may go in two opposing directions: a) potentially more firms taking a license (increasing implementation costs and income for SEP owners) or b) potentially lower royalties paid (decreasing implementers' costs and income of SEP owners).⁴ The latter scenario would place even more costs on SEP owners. If royalty revenues fall and costs of licensing increase, an unintended (yet foreseeable) consequence may be that SEP owners may no longer find collaborative standardisation commercially viable and instead, pursue proprietary solutions that are not encumbered with FRAND licensing commitments.

2. Will there be enough qualified experts working as evaluators?

The Draft SEP Regulation introduces essentiality checks of registered SEPs. Essentiality checks will be conducted annually by appointed evaluators, on a sample of registered SEPs from different patent families from each SEP owner and for each specific standard.⁵ The precise methodology for the selection of a statistically relevant sample will be provided at a later stage by the Commission.⁶ Additionally, each SEP owner may voluntarily propose up to 100 registered SEPs from different patent families annually to be checked for essentiality for each specific standard. Implementers can request the same.⁷ The Competence Centre shall publish the essentiality ratio per SEP owner and per specific standard.⁸

The reliability of essentiality checks depends on having qualified experts working as evaluators. They will need to have specialised knowledge of a particular technological area. The Commission estimates that the number of experts qualified in the EU is around 1,500 (650 patent attorneys and 800 patent examiners).⁹

The sheer magnitude of the task would require many evaluators, and it is unclear if enough qualified experts are available to participate in this process. Patent examiners are already busy and working full-time at patent offices. If they are to be used, then special arrangements will need to be put in place with patent offices to grant them leave to conduct essentiality checks. Furthermore, whether enough patent attorneys and examiners will be available would also depend on the amount of work. As discussed, each year, evaluators would need to test a random sample, and up to 100 SEPs per standard if requested by SEP owners or implementers. Thus, the amount of work may exponentially increase depending on how many standards are covered by the Draft SEP Regulation. In addition, if SEP owners and implementers regularly use the possibility of testing up to 100 SEPs per standard per SEP owner, the vast quantity of work may exceed the capacity of patent attorneys. Patent attorneys

³ Holdout is the behaviour of the implementer to avoid or delay entering a licensing agreement until the SEP owner agrees to below FRAND royalties, see Vincent Angwenyi, 'Hold-up, Hold-out and F/Rand: The Quest for Balance' (2017) *GRUR International* 105.

⁴ Impact Assessment, p. 50.

⁵ SEP Regulation, Article 29(1).

⁶ Ibid.

⁷ Ibid, Article 29(5).

⁸ Ibid, Article 29(6).

⁹ Impact Assessment, p. 101.

may find it challenging to regularly engage in such high volumes of essentiality checks while serving other clients.

Consequently, the market for expert evaluators might lack the required capacity to annually perform a large number of essentiality checks of registered SEPs. The materialisation of any such capacity constraints might lead to lower requirements for the eligibility of becoming an evaluator. This would be problematic as it would put doubts on the reliability of the whole system.

Additionally, patent attorneys may find themselves possessing a conflict of interest. They will have certainly worked for some SEP owners or implementers. Elaborate rules for avoiding conflicts of interest would need to be implemented to prevent patent attorneys who were, or still are, engaged with certain clients from becoming evaluators of their registered SEPs.

3. Competition concerns with aggregate royalty rates

The Draft SEP Regulation introduces a system of notifications on the aggregate royalty rate for a standard. The goal is to provide transparency on the total ‘price’ of the standard. As a first option, SEP holders may jointly notify the Competence Centre of the aggregate royalty for SEPs covering a standard.¹⁰ The joint notification should, among others, include the estimated percentage of SEP holders making the notification from all other SEP owners and the estimated percentage of SEPs they collectively own.¹¹ The joint notification shall be made within 120 days after the publication of the standard by the relevant SDO or after any new implementation of the standard that becomes known to the SEP owners.¹² The aggregate royalty rate may be revised and should be notified to the Competence Centre.¹³ As a second option, if SEP holders cannot reach an agreement, the competence centre may appoint a conciliator to mediate the discussion.¹⁴ Such an option can be requested by SEP owners holding at least 20% of all SEPs.¹⁵ The mediation process should last six months.¹⁶ The third option is for an SEP owner or an implementer to request a non-binding expert opinion on a global aggregate royalty.¹⁷ The Competence Centre will appoint one or a panel of three conciliators, depending on the percentage of SEP owners and implementers participating in the process.¹⁸ Conciliator(s) should produce an expert opinion on the global aggregate royalty rate within eight months.¹⁹

The provisions on aggregate royalty rates raises competition concerns. The participation of implementers in process of providing an expert opinion on global aggregate rates may be used as a vehicle for buyers cartel and could devalue FRAND royalty rates.

¹⁰ SEP Regulation, Article 15(1);

¹¹ Ibid, Article 15(2).

¹² Ibid, Article 15(3).

¹³ Ibid, Article 16.

¹⁴ Ibid, Article 17.

¹⁵ Ibid.

¹⁶ Ibid, Article, 17(7).

¹⁷ Ibid, Article 18.

¹⁸ Ibid, Article 18(6).

¹⁹ Ibid, Article 18(10).

Namely, it is unclear from the text of the Draft SEP Regulation if implementers are allowed to coordinate their submissions to conciliators. If this is provided, then implementers might use the process to exchange commercially sensitive information and agree on the maximum global aggregate royalties they would pay. This would be tantamount to price fixing of input costs and buyers cartel. Even if such coordination is not allowed, by individually submitting their maximum royalty expectations which are made with the goal of minimising input costs, implementers might attempt to devalue SEP royalties. Due to their sheer size, which is much higher than the number of SEP owners, the position of implementers might have an outsized influence on conciliators preparing an expert opinion. On the side of SEP owners, there are also no competition safeguards against the exchange of commercially sensitive information in the process of joint notification aggregate royalty rates. This is different than patent pools, which are expressly required by the Technology Transfer Guidelines to prevent the exchange of sensitive commercial information among their members.²⁰

As a result, instead of bringing clarity, aggregate royalty rates may be used as means to drive down SEP royalties to levels that would not ensure adequate incentives to further innovate in the next generation of international standards.

4. Aggregate royalty rates may be useless

From a practical perspective, the usefulness of a joint notification of aggregate royalty rates can be questioned. The Draft SEP Regulation appears to allow multiple groups of SEP owners to jointly notify their views. This may add even more confusion to the market. For example, a group of SEP owners could announce an aggregate rate of \$10 per end-product, another group announce a rate of 5% of the end-product price, while a third group would prefer a lower \$1 per-product rate. Moreover, many SEP owners already publicly announced their royalty programs in advance, which was recognised by the Commission's studies.²¹ To be on the safe side, SEP owners may simply notify their maximum preference, knowing that negotiations would lead to different prices depending on the unique background of various licensees. As a result, the aggregate royalty rates may not produce meaningful data points.

Moreover, the deadline for the notification of aggregate rates, 120 days from the publication of the standard, also seems unrealistic. SEP owners need to know how a standard will be implemented in final products in order to assess value. Any aggregate royalty rate estimates made prior to the launch of products on the market will only be speculative and unrealistic. Moreover, the experience from patent pools shows that it may take years for patent owners to agree on mutually acceptable and market-realistic rates.²² If experience from patent pools shows that agreeing on rates takes years, why now can patent owners be expected to provide a realistic estimate in only 120 days? The Draft SEP Regulation does provide the

²⁰ Commission, 'Guidelines on the Application of Article 101 of the Treaty on the Functioning of the European Union to Technology Transfer Agreements' (2014) c 89/03, paras 259-261.

²¹ Impact Assessment, p. 84-85.

²² Nikolic, I., 'Licensing Negotiations Groups for SEPs: Collusive Technology Buyers Arrangements? Their Pitfalls and Reasonable Alternatives' (2021) *Les Nouvelles* 350; Brito, J., Alvarez, H-A., 'Patent Pools: A Practical Perspective – Part II' (2022) *les Nouvelles* 39.

possibility for SEP owners to revise their aggregate royalty rate notifications, which seems to anticipate the possibility that initial aggregate royalty rate notifications will not be realistic.

Non-binding expert opinions on global aggregate royalty rates may also add to the confusion. Implementers would likely initiate the process, which would then exist in parallel with SEP owners' joined notifications of aggregate rates. All these different and possibly conflicting estimates might lead to even greater uncertainty and will not lead to meaningful results.

5. Mandatory FRAND determinations – uneven bargaining positions

Mandatory FRAND determinations have an in built disbalance between the parties. According to the proposed SEP Regulation, an SEP holder must commence FRAND determinations prior to the initiation of an SEP infringement claims before a competent court of a Member State. Meanwhile, an implementer must do the same prior to any request for the determination of assessment of FRAND terms and conditions.²³ In other words, implementers are free to challenge the SEP owner's patents– request determinations of invalidity, declarations of non-infringement and non-essentiality, or start opposition proceedings before the EPO – while the SEP owner cannot react by initiating patent infringement proceedings without first going through mandatory FRAND determination process under the proposed SEP Regulation.

6. No incentives for implementers to reach an agreement

The Draft SEP Regulation imposes costs and obligations on SEP owners, while there seems to be nothing to prevent holdout by standard-implementers. In particular, SEP owners need to notify and register their SEPs, pay for essentiality checks, may notify aggregate royalty rates and must enter mandatory FRAND determination processes before being permitted to initiate litigation in the EU. There is no mechanism that would incentivise implementers to accept the results. Implementers pursuing deliberate holdout tactics might simply wait until SEP owners go into the whole process and, if dissatisfied with the outcome, challenge the results of essentiality checks, opinions on aggregate royalty rates and determined FRAND terms. While access to courts must be ensured, a mechanism should be in place to balance the obligations on both sides.²⁴

A suggestion might be to require a proactive approach from implementers once SEP owners register their SEPs. Then implementers might be considered as being notified of the infringement, per *Huawei v ZTE* requirements, and should approach SEP owners for a license.

²³ SEP Regulation, Article 34(1).

²⁴ There is one measure that unsuccessfully attempts to provide a balance. Article 34(4) provides that SEP owners may request from courts to issue a “provisional injunction of a financial nature” against alleged infringers. However, it is unclear what this financial injunction would entail and if the courts have the competence to grant such remedy and under what conditions.

Those implementers that did not approach SEP owners in a timely manner could be required to pay a higher FRAND rate than those implementers which duly entered licensing negotiations after the registration of SEPs. Even so, a better option might be a re-think of the need for such expansive Regulation and whether better outcomes could be achieved by the market, rather than by legislation.

Conclusion

The Draft SEP Regulation pursues noble goals of increasing transparency and certainty to parties in the SEP licensing market in the EU; however, it is doubtful that the proposed solutions will achieve these aims. This brief article highlights some glaring issues with the proposed Regulation. It is hoped that the Parliament and the Council, which still need to review and discuss the proposal, will re-consider the need for expansive regulatory action in this area and conduct robust empirical research on the effectiveness of proposed solutions.