

>> Erica Myers: Good morning. My name is Erica Myers. I'm an attorney with the Federal Trade Commission's Office of Policy and Coordination. And I would like to welcome you to the April installment of the FTC's hearings on the evolving IP marketplace. I want to say hello to everyone watching from the webcast. Before we dive into today's subject matter, I want to remind everyone that we welcome public comments. You can submit those comments through our website until May 15th. We will also be holding our last round of hearings in Berkeley, California, on May 4th and 5th. Unfortunately, those hearings will not be webcast, but the transcripts will be available on our website six to eight weeks, we hope, after the hearings. Let me make the requisite security announcements. Since you've made it into the conference center, you've figured out the metal detector, so I will skip that except to say that every time you leave the building, you will have to go through them again. In the unlikely event that there is an emergency, we'll be told whether to stay or leave the building. If we're asked to leave, our rallying point is across the street at Georgetown Law School. We'll have your name on a list, so please meet us over there to check your name off so any emergency personnel will know that you've gotten out of the building safely and won't have to come running back in to look for you. Also, if you spot any suspicious activities, please let one of the FTC staff or some of the security people that you met coming through the metal detectors know. With that done, let's get to today's topic.

One of the most significant changes to the patent frontier over the last five years has been the development of new markets for patents. Today, we will explore the development of these markets and how patents are bought, sold and licensed. I can think of no better way to start us off on that topic than to introduce Jim Malackowski of Ocean Tomo. Mr. Malackowski has been a visionary in this area and has played a large role in shaping new markets. He's president and chief executive officer of Ocean Tomo, LLC, an integrated, intellectual capital merchant bank firm providing financial products and services related to intellectual property, expert testimony, valuation investments, risk management and transactions. Mr. Malackowski is a member of the IP Hall of Fame Academy and was recognized in 2007 by Managing Intellectual Property Magazine as one of the 50 most influential people in intellectual property. In 2008, he was again named as one of the top 50 IP professionals under the age of 45 in IP law and business as well as one of the world's 250 leading IP strategists by "IAM" magazine. Prior to forming Ocean Tomo, he served as a finance and investment adviser working with one of the nation's oldest investment banks, as well as one of Chicago's largest private equity firms. Mr. Malackowski began his career spending 15 years as a

management consultant and forensic accountant focused on intangible assets. In this capacity, Mr. Malackowski served numerous roles as a founding principal, including president and chief executive officer of his firm, growing the practice to the nation's largest before its sale. On more than 30 occasions, Mr. Malackowski has served as an expert in federal court or the International Trade Commission on questions relating to intellectual property economics, including the subject of business valuation and the impact of advertising programs. As an inventor, Mr. Malackowski has ten issued U.S. patents and an even larger number of pending applications. He is an adjunct professor of law at Chicago Kent College of Law as well as an adjunct instructor at the University of Notre Dame Mendoza College of Business where he was a summa cum laude graduate, majoring in accounting and philosophy. I could go on listing his accomplishments and experience for a lot longer, but I suspect you would much rather listen to him, so I will turn it over to Jim.

>> James E. Malackowski: Thank you, Erica, and thank you to the commission for inviting me to share a few views today. For those of you on the webcast, there is a rather extensive presentation that's been posted that would literally take the balance of the day to discuss in detail. But in the next 30 minutes, I'm going to give a brief introduction to our view of the developing marketplace, and I'm going to try to hit on just five specific market developments that we think to be of most significance. Focusing on slide three of the deck, it's an analysis that many in the room who are often dear friends here have seen before. Which is looking at one example of the public equity markets. This is the S&P 500. But I think it is always important to put in historical context the great progress that we've already made in IP marketplaces. So put yourself back in 1975 as the CEO of a public company, and let's suppose your company was worth \$10 billion in the marketplace. You would find on your balance sheet \$8.3 billion worth of stuff, property, plant, equipment, and cash. And I think we've forgotten how generally small the premium the market gave you to those tangible assets. The way you had a higher market value was to simply work the machines harder, move the factory quicker. Fast forward to today. Even after the market correction of 2008, and if you're the CEO of that same \$10 billion company, your balance sheet only shows \$2.5 billion of tangible assets. Yet the market is giving you a very large premium based largely upon your intellectual property. The quality of your brand, the quality of your technology, your customer relationships, et cetera. And so Ocean Tomo's business and our focus has been understanding the components of that intangible asset bar, helping to bring greater transparency, greater data and greater information.

If you advance to slide five of the deck, this is an analysis that we just recently completed, and I can discuss perhaps in the question and answer session more detail in how it was determined. But briefly, it was based upon results that we have from equity indexes that are grounded in patents. But our conclusion, as of today, is that roughly 22.5% of the market cap of most large cap companies, in this case as represented by the S&P, is reflective of asset values specifically attributed to patents. So the marketplace for intellectual property and for patents is a very large opportunity as represented by that value. With those introductory remarks, I'd like to focus on five elements of what we call the developing IP infrastructure. And it's really five specific points to a larger agenda which on slide seven describes valuation standards, new efforts to track inventory, new policy leadership from the Obama administration, the evolution of standard contracts, but then primary markets, derivative markets and related reporting. Topic one that I'd like to focus on is valuation standards.

When I started in this business in the mid-1980s, I think my first client opportunity was to appraise a patent for sale, not for litigation. And as a young analyst, I ran down the hall to the senior partner's office and explained that we were going to do an appraisal of a patent for sale. And I was told no. I was told, we cannot sign the firm's name to an opinion letter because it was not covered by GAP, it was not covered by FASB, it was not covered by their insurance. And although I protested, I was told to call the big eight accounting firms when we had eight such things. And they basically all told me the same result. They'd be happy to advise my client on value, but they were not going to sign Price Waterhouse, Arthur Anderson, et cetera, to the bottom of an opinion letter of patent value. We've changed a lot. If you look on the screen in chart nine, the standards have evolved significantly so that today, it's a common occurrence to walk into any of a number of accounting firms, economic firms, or otherwise, and they will provide you that insight into the marketplace. I think what's most important, though, from our perspective, is the ability to extend the valuation analysis to a larger, more objective study. The analogy that I use for this is credit rating. Everyone in this room perhaps has a home mortgage, and perhaps your home mortgage is, let's say, \$100,000. But how could anyone invest in your mortgage because it's so different? Your house value to mortgage value is different than mine. Your income to your mortgage payment is different than mine. Your ability to pay that mortgage and your credit history is different than mine. But with the credit score, things come into greater focus. And that if your credit score is an 800 and mine is a 720, knowing just that one data point, intelligent decisions can be made about the risk

associated with that loan. The same is true for intellectual property, and not only Ocean Tomo, but a number of firms have begun to develop rating systems based upon their own algorithms or, in our case, simply observing what the marketplace is telling us. On slide ten is the output of such a form, and it's really driven off of slide 11, which is an observance of the patent maintenance market. And of all the things I'm going to speak to today, I think this is probably the most important. Over the last 100 years, certainly the last 25 years that's reflected on this chart, there has been an active but underappreciated market for intellectual property. And that market is, in fact, the patent office itself, and the actions of patent owners as to whether or not to maintain or abandon their patents. And for those of you who know, in order to get a patent with the U.S. government, not only do you pay a fee once, but you pay a fee approximately every four years, and those fees increase. And if you look at the collective body of work, less than half of all patents are maintained for their full term. In other words, those owners have decided it is not worth the expense to keep them. And so one of the things that we've tried to do is we have tried to observe what information can be gleaned from that market. In other words, imagine an experiment where we put on the left side of the room all of the patents that have been maintained over the last quarter century. So we have literally millions of observations. And put on the right side of the room, all the patents that were abandoned. Which pile do you think is more valuable? One would suggest the ones that people kept. And it turns out, if you identify all of the objective metrics like area of technology, number of claims, the lawyer, the examiner, and you run the statistical models comparing those two data sets, they are, in fact, very different. In general, patents that people maintain are different than patents that people throw away based upon those criteria. The question is, is it meaningful, and does it matter? And I'm not going to go into all anecdotal studies that we've undertaken to address that issue, but I'm going to refer to two. First is on page 13. We looked at the 1,000 largest publicly traded companies. And we compared their gross profit as one indicator of the value of patents, believing that patents can provide features that you can charge more for. Patents can provide manufacturing techniques that allow you to lower your cost, or patents can protect markets that give you economies of scale. From the accountant in me, those three benefits all drive gross profitability or gross margin. So we undertook a study to determine whether or not companies with higher quality patents as determined from the statistics had higher gross profits. And as the study suggests on chart 13, there was an 86% correlation. So for the first observation, what we learned is that, generally speaking, companies with more, better patents perform better. The issue, though, was chicken or egg. Was it

companies with high margins went out and hired great lawyers and got great patents? Or was it the great patents that got them the higher margins? And for that, we went to Wall Street, and we hired a firm, Ned Davis Research, and provided them 15 years worth of observed data from the patent maintenance marketplace. And we asked them to create a wide portfolio of stocks, which we called the Ocean Tomo 300. And to purchase stocks on a quarterly basis knowing only the financial information at the time and the patent statistical scoring. And when they created that index, as showed on slide 14, it outperformed the market generally, essentially for 15 years consistently, in 82 of 85 rolling periods. And not only did it outperform from a return basis by 200 to 800 basis points, it did so at a preferred sharp ratio. Meaning it was less volatile, less risk. So if you go to the Mendoza College of Business at Notre Dame, and you ask finance professor, "can I take a one-factor model based upon patents and outperform the market consistently for 15 years at a lower risk profile?" And the answer would be no, such things are not possible. The market is efficient. But we know it is possible because the marketplace heretofore hadn't understood the value that patents bring because they didn't have the information or the data. And by allowing them to look at these rating systems, by allowing them to look at the performance of equities in the market, they're beginning to understand.

I'd like to look to a second marketplace, and I'm going to jump forward to primary markets on slide 30, which is the Ocean Tomo marketplace. In 2005, one of my partners sat with me, and we discussed ways to increase the efficiency of selling intellectual property. And he held up a catalog very similar to the one I'm holding here, but it was for a car auction. And he said to me, "well, why don't we sell intellectual property at public auction like Sotheby's sells paintings or Gooding's sells automobiles?" And frankly we laughed at the suggestion because clearly it could not be possible to do sufficient diligence on unique patents in a very short time period and then raise your hand in a public forum and acquire them. But he protested, and we continued, and eventually did launch the first patent auction in April of 2006. And at that event, there were more than 400 in attendance. The auction lasted 2 1/2 hours, and all 400, including a number of former patent commissioners and chief intellectual property officers sat in neat rows of chairs and didn't move. But they took a lot of notes. And what we found significant about that first event was not the sales, but the price discovery. Because that was really the first time ever in an open forum property you could understand what someone else's intellectual property was worth. Since then, we've conducted nine auctions as shown in slide 31, which had generally increasing results both in

total volume and average pricing. We finished our last auction a few weeks ago in San Francisco, and the volume was down, we think, largely due to the economy, but the average pricing was, in fact, maintained. And so, what we now view as auction marketplace represents episodic price discovery that occurs three times a year, which is helpful. It's insightful, but it's insufficient. And so market number three extends the auction results to a larger platform which we call patent bid ask. So if you go to the internet, this is shown on slide 32, to patentbidask.com, what you'll find there is every patent listed in the world -- 33 million of them. And if they've been sold and that data has been publicly reported, you'll see the price at which that patent transacted. If the owner of that patent wishes to sell it and is willing to post publicly at ask, you'll see the ask. If someone wishes to buy the patent anonymously, you'll see the bid. And so in many respects, this mechanism is creating further discovery, not only by industry, but by geography. When we launched this platform last summer, what surprised me the most is that the phone rang, but it's where the calls were coming from. We received calls from Poland, from South America, from Asia. And essentially the calls went as follows. "We, in Poland, believe that Polish companies would like to buy and sell Polish patents between themselves. But there's no way to do that. There's no mechanism. There's no marketplace. Can Patent-Bid-Ask provide that forum? Can we translate the standard documents that you use for a transaction into Polish and begin to facilitate that market?" To which we said yes. And so the experiment that is taking place now is to watch as that market develops over the next two to five years. Will it be Brazil? Will it be Taiwan? Will it be biotechnology? Will it be computer technology? The discovery, again, will be, I think, interesting and informative for all who participate.

Market number four. The intellectual property exchange international. Referring first to slide 33. Three years ago, the state of Illinois came to us with a request to give thought to a traded exchange for intellectual property. Chicago has a long history in exchanges, most recently the climate exchange. And basically the request was if we can, in fact, trade carbon credits on an exchange, why can't we do the same for intellectual property? So they provided us a grant, and we set out about a two-year study trying to develop markets and models that would allow us to facilitate a more robust, transparent and otherwise efficient exchange of intellectual property. And I'm going to refer briefly today to two such products. The first one is shown on slide 33. It's called a unit license right. So let's talk about how the transfer of technology from licensing is historically done. And most in this room are either patent attorneys or in-house counsel, so you'll be familiar

with my example. If a client were to call me and ask me to help them license their technology, and let's pick the automotive industry, because it's one of my favorites. So a big three company in Detroit would like to license one of its patents to a Japanese manufacturer. We know how that process works. You'll spend some time trying to contact and arrange a meeting with the potential licensee. And that sometime may be one, two or six months. By the time you finally arrange that meeting, the focus of that meeting is not on the benefits of the technology, but the licensee's opinion as to why the patent is invalid, and why it's not necessary. That process to overcome takes another one, two, three or six months. And once you finally convince that potential licensee that, yes, there is indeed value in that asset, you start phase three, which is their rolling out of their own patent portfolio trying to explain how their assets could be a benefit to the licensors, and why don't we just end up in a cross-license. So most tech transfer today in our view is, in fact, done that way, either on an individual cross-license or large portfolio cross-license. That is not a transaction that brings transparency. That is not a transaction that really attributes value to those assets that are, indeed, the most valuable. So we believe that tomorrow the process will look differently. Tomorrow you'll receive a call to license intellectual property, and it will be very much like offering the secondary share of stock. So in my example on the screen we're looking at the 137 patent. And Ocean Tomo or other firms in this room would serve as an underwriter to study the technology, describe the market opportunity, and then structure and offer to the market that it's probably some subset of expected demand. So if we believe in my example that the 137 patent could be used on 10 million cars and trucks, we may go to the market with a subset of 5 million. And we'll go to that market at escalating pricing. So the first million will be at 50 cents a car. The second million will be at 75 cents a car, and the last 3 million will be at \$1. The auto company would then exclusively license this patent to the exchange, authorizing the exchange to issue the 5 million sub unit license rights at those prices. Now, why does that make any difference? Well, first, if there is a willing licensee, the process is now very simple. They call their broker. They say, buy me 200,000 U137As, bid 51 cents. that order is filled on the open market. And they're able to place those assets on their books as assets, not an expense. As they consume them, they expense them. If they don't use them all, they can sell them back. More specifically, though, this allows for third-party investors to enter the marketplace. It is our opinion that you cannot create an efficient market for intellectual property, or frankly any asset, simply limited by those who create the asset IP and those who consume it, users. You have to have liquidity. And so in our example, an

investment fund could look at the prospectus and say, "Wow, the opportunity is far greater than we anticipate. We're going to buy units at 50 cents to resell them at 75 cents. Or, in fact, we think the opportunity is overstated. We'll short them at 50 cents and cover at a dime." That liquidity into the marketplace allows for greater activity and sale by the original issuer, in this case, the automotive company. The second big difference is that the exchange will have the enforcement rights. If we have a party after this conference today, and our deejay plays Michael Jackson and that deejay did not pay ASCAP, there is, in fact, an enforcement committee that will track him down and collect the 50 cents or \$5. The IP traded exchange will operate the same way. So if the enforcement committee believes that a European auto manufacturer has not acquired units on the open market but is, in fact, using the technology, they'll contact the European manufacturer and politely encourage them to buy. If that's unsuccessful, they will have the right to sue that manufacturer. And once they sue that manufacturer, they're not interested in a cash settlement. All the exchange is interested in is having that manufacturer go to market and acquire units at the market price. Ultimately that case could go to trial. If they're successful, there will be a damage award which will be used to acquire units. If they're unsuccessful, the patent will be shown to be invalid or not infringed, and the price of the market will reflect it accordingly. IPXI set out about four months ago to identify potential interested issuers for unit license rights with the objective of finding a beta transaction to launch yet this year. They visited 20 different companies and universities, and 18 were interested. Some were so interested, they actually bought seats on the exchange. It's now their expectation that they will bring the first unit license right to market in the third or fourth quarter. So this is no longer simply theory. This is evolving quickly into practice. And it's our belief that, starting in 2010, there will be an active market, at least a primary market, for unit license rights.

Slide 36. I would like to talk now not about primary markets for actually buying, selling or licensing technology, but speak to derivative markets. So one of the indexes that's received a lot of discussion because of our economic conditions in the housing market is the Case-Shiller Index. And if you're not familiar with the Case-Shiller Index, it is an index that tracks the price of residential homes in various markets around the country and presents that in aggregate view. And based upon that index, investors can either buy the index long or sell the index short and give them investment opportunity or hedging opportunity to real estate. When you buy the Case-Shiller Index, you don't actually own a piece of anybody's house. You simply own the financial future contract

right. We believe, through IPXI, the same will develop for patent indexes. So let's look at the illustration on slide 36, and we can continue with the automotive industry. The blue line represents a company's patent portfolio. So imagine if we took the statistical scores of one of the big three auto manufacturers, and we totaled them and plotted them weekly over a period of time. The blue line is what you would expect. It would be relatively stable, slightly increasing. The brown line on the chart represents a product. So perhaps this is not the big three manufacturer's total portfolio. Perhaps it's their hybrid electric patent portfolio. It's what you would expect. A subset of the blue line, more recent, rapidly growing. The black line represents a category. So this represents the statistical patent scores or ratings for hybrid electric technology across all manufacturers. The big three, the Asian, the European, all aggregated together. Well, this data is relatively transparent because people can understand how it was calculated. It's relatively consistent. And the question is, is it useful? So go back to the Case-Shiller Index. What the purpose of these patent indexes will be, as they're called tradable technology baskets, is to exactly write financial futures contracts against them. So now for the first time, investors can decide, do I want to own the stock of the big three company? Or would I rather buy the financial future contract related to the intellectual property alone? And they could do that for speculative reasons. They believe that the company's got strong technology. They could also do it by category. If your personal opinion is that hybrid electrics are the future, and you call your broker and say, put my money into hybrids, well, what does she do? She buys you shares of Ford and shares of Honda and shares of Toyota, but that's not what you want. That has labor risk, manufacturing risk, political. You just want to invest in hybrids. This technique will now allow you to do that. More importantly, it will also be used for hedging. Suppose that you like Toshiba as an equity. But you knew that Blu-ray would win and HD DVD would fail. So you hedged your Toshiba equity investment by buying a Sony Blu-ray patent contract. When I go to intellectual property conferences, and I talk about tradable technology baskets, I get a lot of inquisitive looks, to say the least. When I go to the Chicago Mercantile Exchange, it doesn't take me this long in the conversation. Because in about three minutes, they totally understand it and want to know when it's going to start trading. And the reason is back to that first bar. There is an appreciation that intellectual property and patents represent a significant portion of corporate value. But there is no way for investors today to access or to break it out or to otherwise trade it. We believe that IPXI will be effective trading. I'm going to finish up in the time allowed to talk about one aspect of unification. The efforts that I have described about valuation

standards, patent auctions, ratings systems, is, in fact, largely related to the activities that Ocean Tomo's been working on in the U.S. But as shown on slide 43, this activity is occurring not just by Ocean Tomo, and it's not limited to the U.S. In Japan, there is a rating of business, intellectual property Bank of Japan has their own rating service. There are rating services being developed in Europe. There's been a separate auction held in Europe. And in our opinion, the evolving IP marketplace is building these modules or building blocks in the U.S., in Europe and Asia with the objective of eventually linking them together. And I'll leave you with one last thought example as to the power of these developing markets.

Let's pretend now we're not at the CEO of the public company, but we're at a trade convention in the telecom world. And each of you represent an individual company, be it Motorola, Panasonic, Philips, you pick your favorite. And you brought with you today your stack of patents, your European patents, your American patents, your Asian packets. Some stacks are small, couple thousand, some stacks are large, tens of thousands. Which stack is best? If you had unlimited resources and a lot of time, could you figure out which stack is best? I would suggest probably not. And if you came back with an answer, certainly not many are going to agree with you. But let's suppose that the marketplace evolves in the way that we believe that it will. That a ratings system which exists in the U.S. today is re-created in Europe and re-created in Asia. And what will tie those together are the foreign counterparts of each of those patents. So in the introduction, it was mentioned that I have been issued a few patents under my name. And so let's say that we take one of the Malackowski patents, and we rate it in the United States using the U.S. ratings system. And it comes back 100. On a bell curve, 100 is completely average. We take the foreign counterpart of the Malackowski patent, and we rate it in Europe only amongst European patents, and let's say it comes back, and it's rated 120, meaning that same technology or invention is not average in Europe, but slightly better than average. We could rate it in Asia. And perhaps it comes back an 80, meaning it's a slightly less than average quality amongst Asian patents. Well, that one data point alone may not be too illuminating. But that one data point would suggest that, if that was representative of every patent, that patents in the U.S. are actually a little better than the ones in Europe, and not as good as the ones in Asia. And if you repeat that experiment 10,000 times, our belief is that you will find a meaningful currency conversion for intellectual property. So when we're back at the Telecom convention, and you all brought your stacks of 2,000, 4,000, 10,000 patents, and run through the rating systems by geography, you will very quickly come up with an

equivalency. Mine is 80% as good as your stack. Now, we still may not agree that that solves all the problem, but like that credit score, it would give us a place to start the negotiation. It will give us a place to discuss balancing payments. And it's a way for the marketplace to begin to get their arms around this asset. One of my final comment is reflected on page 43 at the top of this chart there is a site called oti.com. And what we have done at OTI is our best effort to aggregate all public IP market data in one place. So for free, just a simple registration of your e-mail, you can enter a patent number, a technology, or a company. And if you enter that data what will come back to you is, has this patent been sold? If so, at what price? Is it for sale, if so, what price? Is this patent a subject of a license agreement that's kept in the royalty source data base? If so, what's the license rating of that patent? Has this patent been rated? If so, what is the rating? Is this patent part of a tradable technology basket that's currently published on OTI? If so, what does the index look like? And so in some respects, my apologies to Bloomberg, but I equate it for the Bloomberg for IP because it allows you in one place to begin to get that price discovery in transparency so that you can make better, more informed decisions.

My final thoughts, we were talking before the conference about the state of the market generally and all the initiatives to correct and modify and reform. And in my views, the patent marketplace is evolving at light speed. But the context you have to put it in is not 12 months or 2 years. It is the context of the last 10 to 25 years, that first chart I showed you where industry went from being largely dominated by tangibles, to today it's largely dominated by intangibles. And 25 years in macroeconomic cycles is light speed, and the market is evolving very quickly to present new opportunities for transfer, new opportunities for measurement, new opportunities for valuation. And although there may be need for tweaks along the way, the system in our view is, in fact, working. The system is becoming more efficient, and intellectual property will continue to become a greater focus of management and investors as that trend continues. So thank you very much for your time today. And we can, I'm sure, go into some of these issues in more detail as we start the panel discussion.

>> Thank you, Jim. And we are going to take a quick break and starting up again at 10:15.