On Nascent Competition in Merger Analysis

Comments of Anant Raut[1]

In this paper, I discuss potential flaws in the traditional antitrust approach to nascent competition where small serial acquisitions or network effects are involved.

The entrenchment of a small number of monopolists in billion-dollar markets seems paradoxical to the idea that tech markets are democratic, meritocratic, and constantly evolving. This has led some critics to question the adequacy of antitrust in protecting nascent and potential competition. While it's true that no monopoly lasts, some may have lasted longer than they should have by preventing competition from ever reaching scale.

The criticism is rooted in a counternarrative to the Silicon Valley emergence story: that the Valley as fertile cradle of innovation is a myth, and that in reality, the tech boom is camouflaged externalized R&D for a handful of tech conglomerates. Its premise is born out in part by the fact that the exit strategy for many startups is to get bought up by one of the tech "unicorns."

Some have responded by calling for breaking up the big tech companies. Breaking up a company is certainly within the arsenal of antitrust remedies, but it's a nuclear weapon and should be used as such. Nor is it clear that breaking up the conglomerates will redress the harm from the platforms that is being cited. For example, how would requiring Google to divest Waymo and YouTube solve concerns about its search engine market share? How would separating search as a standalone product from search advertising, its revenue source, even work?

Just inside of that approach is the more interesting suggestion that for companies over a certain size, all acquisitions should be presumptively anticompetitive, regardless of horizontal overlap. The idea isn't that far-fetched; antitrust has long promoted internal innovation and development, and cast a far more skeptical glance at growth through acquisition. But the assumption that once companies reach a certain size, *any* acquisition enhances their market power and is anticompetitive, is hard to square with the fact that historical conglomerates such as GE and Tyco don't dominate the market today. The larger and more diversified companies become, the more bloated and less efficient they tend to be, opening the door to nimbler competitors fighting them alleyway by alleyway in just one or two markets. So some credit has to be given to the tech conglomerates for managing to stay competitive *in spite of* their size, not because of it.

Harm to nascent competition may be undervalued in certain serial acquisitions and in markets with network effects

But the dominance of some of these unicorns may result from traditional merger analysis undercounting two types of harm to nascent competition. The first is the unique harm posed by

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acquisitions in markets with network effects to nascent competition in smaller, adjacent markets (scenario 1). The second is found in a particular type of serial acquisition, the "acqui-hire" (scenario 2).

- *Scenario 1* – Harm to adjacent markets

In my *Wired* article[2], I discussed how traditional antitrust analysis may miss anticompetitive effects in markets adjacent to the acquiree in which the acquiror operates. At the time, I talked about the potential harmful effect of the Amazon-Whole Foods acquisition on the smart home speaker market. Tech titans that operate with a network effect present a unique competitive concern with their acquisitions. The network effect for Amazon is Prime. Once consumers become Prime members, their shopping habits change. They are likely to lean or be nudged towards purchases within the Prime ecosystem, making it significantly harder for competitors outside of the Prime ecosystem to lure them simply by competing on price or service. If Amazon were to integrate Whole Foods shopping into the Prime ecosystem, and incorporate it into its Alexa devices, that could nudge millions of potential consumers toward the Amazon family of companies in the smart home speaker market, crushing nascent competitors in an emerging field.

A recent BusinessWeek article[3] discusses how a handful of Chinese tech titans use their network effects to pick winners and losers in smaller, adjacent markets:

> "The power of Alibaba, Tencent, and Baidu, Inc. 'to decide which companies succeed or fail in China's vast consumer and corporate markets has become both outsized and unprecedented…' And if anything, the Chinese tech giants' size doesn't even begin to indicate the true extent of their influence. In some cases, their cash hoards may matter less than their ability to tilt a given market toward one startup or another through access to their massive audiences."
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> "Pinduoduo…probably wouldn't exist without Tencent's ubiquitous messaging platform, WeChat. Tencent's chat app helped PDD acquire 344 million customers, who obtain discounts by flagging products to friends on the service."

Solutions

In terms of <u>policy prescriptions</u>, a potentially better way to analyze these transactions is for there to be a structural presumption against acquisitions by companies over a certain size whose market power is **meaningfully enhanced by network effects**, a presumption that may be rebuttable by open interface/interoperability.[4]

The challenge in nascent competition analysis is quantifying the harm and constructing the but-for world with any degree of certainty. Enforcers should move beyond price and output analyses to find proxies for innovation in these adjacent markets. Proxies may include the rate at which

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[2] Tiku, N., "Ready for a Monopoly Fight? Amazon Whole Foods Isn't It," *Wired.com* (June 20, 2017).
[3] Banjo, S., "China Startups Struggle to Escape the Shadows of Alibaba and Tencent," *Bloomberg BusinessWeek* (August 15, 2018).
[4] The FTC pursued just such a remedy in *Nielsen/Arbitron*, Decision and Order, *In the Matter of Nielson Holdings, N.V. and Arbitron, Inc.*, Docket No. C-4439 (February 24, 2014).

market shares change, or the frequency with which the market lead shifts. Proxies may also include the number of patents filed (used in the European Union's Dow-Dupont investigation), or the frequency with which updates and new features are rolled out.

In addition, given the lock-in that occurs with network effects, these are markets where we should reject the Borkian approach and weight false negatives more harmful than false positives.

Lastly, enforcers should also forcefully reject the argument not to intervene because certain markets are by nature winner-take-all-or-most. Tech markets based upon network effects often tip towards monopoly because the value that these companies present is centralization of certain functions (e.g., social contacts, goods for sale). And I wholeheartedly agree with Dr. Fiona Scott Morton's observation from Day 1 of the workshop series: in markets that tip towards monopoly, the competition is not for market share, but for the market. This *does not*, however, mean that these markets should be treated differently because there is only room for a single competitor – such an argument was firmly rejected by the Supreme Court in *Penn-Olin*.[5]

- *Scenario 2* – "Acqui-hires"

There is a particular type of acquisition among serial acquisitions, the "acqui-hire," that may be the cleanest nascent competition case to examine, and where harm may be measured by limitations on the free flow of human capital.

Critics have pointed to serial acquisitions in the tech industry, in which many small, innovative companies are absorbed by a handful of incumbents, as a way for dominant companies to preserve their market share by nipping off future competition. Often, these transactions aren't even reportable and the deals themselves in isolation don't present any competitive problems. However, by focusing on individual transactions, the enforcement agencies may be missing the cumulative effect of having so many small, innovative companies being absorbed by a handful of incumbents.

"Acqui-hire" is shorthand for a type of acquisition seen commonly in the tech space where incumbents buy companies for their engineering talent and abandon the original product. Acqui-hires may be the easiest harm to innovation case to make, since whatever few (if any) benefits there are to taking a startup out of the market will almost certainly be outweighed by the potential harm to competition. Acqui-hires don't make a lot of business sense – why buy an entire company that you don't intend to continue operating if you only want some of their employees? Why not hire those employees directly? One plausible explanation is that the startup's investors are demanding to get paid out before releasing their key personnel.

[5] *U.S. v. Penn-Olin Chemical Company et al.*, 378 U.S. 158, 173 (1964). "In this regard the [lower] court found it 'impossible to conclude that as a matter of reasonable probability both Pennsalt and Olin would have built plants…' We believe the court erred in this regard. Certainly the sole test would not be the probability that both companies would have entered the market. Nor would the consideration be limited to the probability that one entered alone….The existence of an aggressive, well equipped and well financed corporation engaged in the same or related lines of commerce waiting anxiously to enter an oligopolistic market would be a substantial incentive to competition which cannot be underestimated."

Solutions

In terms of policy prescriptions, enforcers may want to examine why acqui-hires require the purchase and dissolution of an entire company, as opposed to the less expensive and more targeted hiring of the desired employees. To the extent the free flow of human capital is being impeded by investors demanding to get paid out first and acquirors wanting to stay in those investors' good graces, *this restriction on labor movement is just as harmful as the Silicon Valley no poach agreements* that artificially held down the price of professional labor in violation of the antitrust laws.[6] Similarly, any such tacit agreement between acquirors and investors may violate Section 1 of the Sherman Act.

In addition, harm to nascent competition can be mitigated by stipulating to the removal of non-compete agreement except in very limited circumstances involving actual trade secrets.[7] Such a requirement could *spur* nascent competition. By making the entrepreneurs running the acquiree wealthy and financially secure *and* able to move around, the agencies can increase the likelihood that such employees will leave the acquiror within a few years and launch something even more daring and innovative.

Lastly, the agencies should forcefully reject the argument that challenging these acquisitions will have a chilling effect on investment. The same spurious argument would be rejected in defense of pay-for-delay as a business strategy. If your investment strategy depends upon illegal anticompetitive activity, that doesn't mean you get a pass from the antitrust laws.

[66] *See,* e.g., *U.S. v. Adobe Systems et al.*, Complaint, 1:10-cv-01629-RBW (September 24, 2010); *U.S. v. eBay, Inc.*, Amended Complaint, 12-CV-05869 (June 4, 2013).

[7] Non-compete agreements are largely unenforceable in California, and credited with facilitating innovation there.