THE SHERMAN ACT COMES FOR BIG TECH: CUI BONO?

They’re big and maybe bad…

The Lead In

- In a court filing on October 9, 2024, the US Department of Justice (DOJ) let it be known that it was considering a break-up of Alphabet, with the addendum that it would also be pushing for the company to share the data it collects across its multiple platforms with competitors.
- It is entirely possible that these are threats designed to extract more concessions from the company, but the break-up talk is a continuation of a debate about the power accumulated by big tech companies, in general, and with Microsoft, Amazon, Apple, Alphabet and Meta, in particular, and what should be done about that power.
- With politicians, economists and lawyers all in the mix, offering widely divergent solutions, I look at the evolution of anti-trust law in the United States, and whether that law can or should be used to counter big tech.

Anti-trust Law: Robber Baron Origins

- In the latter part of the nineteenth century, as the United States was transitioning from an emerging market to a global economic power, its growth was powered by three industries - steel, railroads and oil - all requiring large investments in infrastructure.
- In each one of these businesses, powerful men earned their "robber baron" standing by squashing competition and building dominant companies that aspired for pricing power.
  - In oil, it was John D. Rockefeller, who started Standard Oil and built a sprawling empire across the nation, acquiring other players in the still nascent oil business.
  - With Carnegie Steel as his vehicle, Andrew Carnegie took control of the growing steel market, before selling his business to J.P. Morgan, who took it public as US Steel.
  - In railroads, a network of tycoons controlled swathes of the country, with Cornelius Vanderbilt, Jay Gold and Leland Stanford all playing starring roles, as heroes and villains.
- Along the way, they created the trust structure, organizations of companies which controlled production and prices, effectively monopolizing the businesses.

The Backlash: The Sherman Act and Teddy Roosevelt

- As these companies laid waste to competition, exploited labor and overcharged customers, a political and economic backlash ensued, manifesting in the Sherman Anti-trust Act of 1890 and the election of a Teddy Roosevelt, campaigning as a trust buster.
- The Sherman Act used the constitutional power of Congress to regulate interstate commerce to authorize the federal government to break up the trusts and "restore competition", with the latter words vaguely defined.
  - While the law outlawed "every contract, combination, or conspiracy in restraint of trade," and any "monopolization, attempted monopolization, or conspiracy or combination to monopolize", the Supreme Court added the constraint that the law only forbade competitive restraints that were "unreasonable".
  - That vagueness initially worked against the government, in its enforcement of the act, with the Supreme Court ruling against it in its attempt to break down the American Sugar Refining Company, in 1896, but the kinks were worked out in the next decade.
  - In 1911, President Taft used the act to break up Standard Oil into multiple oil businesses, and the entrails of that breakup can be found in many of the largest oil companies of today.

Augmenting Antitrust Law: The Clayton Act

- In 1914, Congress passed the Clayton Act to clarify and augment the Sherman Act, and expanded its reach to cover a whole host of activities that it classified as anti-competitive, including some mergers, predatory pricing and sales ties.
- It also barred individuals from sitting on boards of competing companies and created the Federal Trade Commission (FTC) as an institution to provide the specifics on what constitutes unfair competition and to work with the Department of Justice, to enforce these rules.
- In subsequent years, Congress returned to add provisions and modify the act, including
  - the Robinson-Patman Act in 1936, which reinforced the laws against price discrimination
  - the Celler-Kefauver Act of 1950, which filled in gaps on the merger provisions, and
  - the Hart-Scott-Rodino (HSR) Act of 1976, which introduced the need for any company planning an acquisition that exceeded a transaction value threshold (reset at regular intervals) to file a pre-merger notification with the Justice Department and to wait at least thirty days before consummating the acquisition.

Enforcement Agents

- The effectiveness of laws at dealing with the problems that they purport to solve depends in large part on how they are enforced. In fact, one reason that the Clayton Act created the Federal Trade Commission in 1914 was to enforce the anti-trust laws
  - The FTC states its mission as protecting *"the public from deceptive or unfair business practices and from unfair methods of competition through law enforcement, advocacy, research and education."*
  - In carrying out this mission, the FTC often relies on the Department of Justice (DOJ), where an antitrust division was created specifically for this purpose, in 1919.
- Ultimately, though, it is the courts that decide whether the FTC (or DOJ's) case has merit.

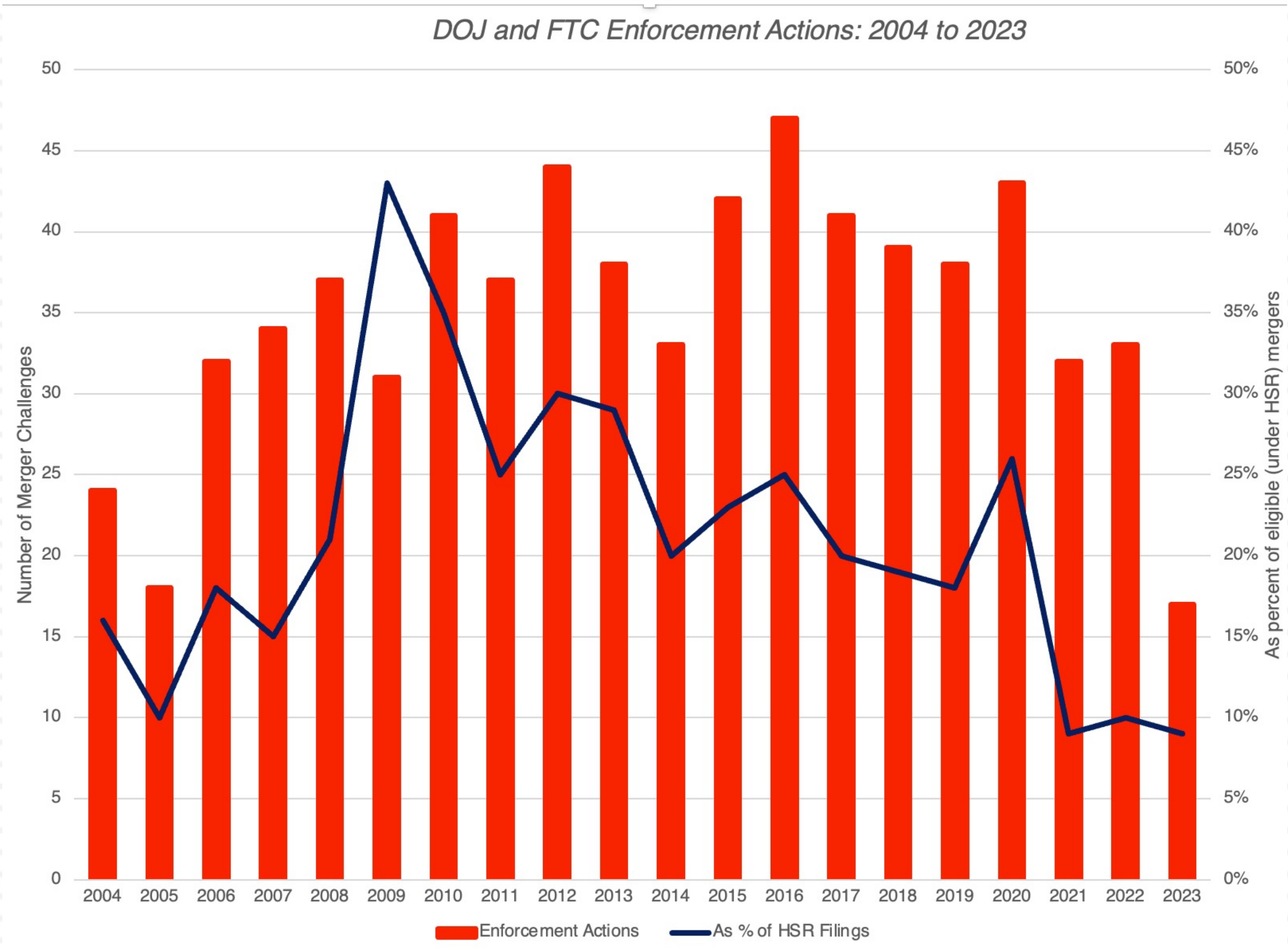
The Ebbs and Flows

- Through the history of anti-trust laws in the United States, the enforcement has ebbed and flowed, partly as a result of changing administrations bringing in very different idealogical perspectives on its need, partly in response to Court judgments in its favor or against it, but mostly because of questions about *whether the central objective of the laws is to enhance competition or to protect consumers*.
- The divide between enhanced competition and consumers played out in competing viewpoints, with one school, led by Robert Bork, arguing that the original intent of the law is consumer protection, and the other pushing back that the end game of the law is to stop cartels and monopolies, i.e., enhancing competition.
- That tension continues to underlie much of the debate of the law today, in both political and economic circles, and will come into play if the DOJ pushes ahead trying for a big tech breakup.

Big Tech: The Lina Khan Argument

- For most of the last few decades, the consumer protection argument has resonated more strongly with courts and has played out as a restraint on what actions the FTC can take, and how far it can go in enforcing antitrust law.
- It is this context that Joe Biden's choice of Lina Khan as the youngest person to head the FTC was viewed a signal of change in focus, since Ms. Khan's most well-read treatise, *Amazon's Antitrust Paradox*, written while she was still a student at Yale, argued that the company's increasing power was hurting both competitors and consumers.
- In that paper, she posited that platform-based companies prioritized growth over profits, using their platform size to decimate competition, and that antitrust laws would have to be retooled to rein in these companies.
- The central part of her argument is that while Amazon's consumers benefit in the short term, because of lower prices and better service, they would lose out in the long term because less competition leads to less innovation and fewer choices.

The Lina Khan Effect: Muted…



But higher profile, in public…

- That graph, though, does obscure the fact that the government has been more aggressive about challenging high profile mergers, and publicly proclaiming its intent to do so, in others.
- The results have been mixed, with wins in a few cases coming with losses in several others, with the failure to stop Microsoft's acquisition of Activision representing one of it s highest profile losses.
- In short, while Ms. Khan's argument for use of antitrust laws to restrain platforms may have found a receptive audience among some legal thinkers and politicians, it has not won over the courts (at least as of now).

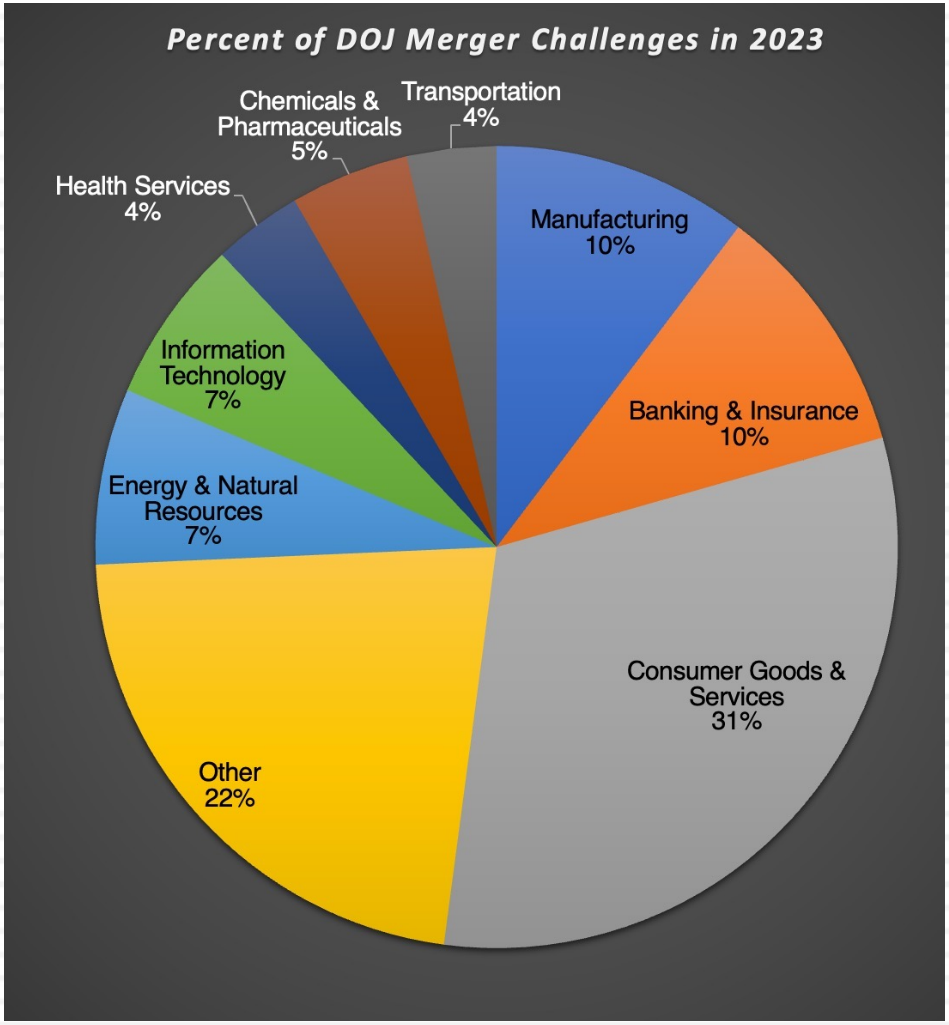
The Remedies
1. Operating Restraints and Changes

- The anti-trust laws give the government the power to affect how a company operates by stopping it from acting (by acquiring another company, introducing a new product or entering a new market) or changing its behavior (in terms of pricing it products and operating its business), in the interests of increased competitiveness.
- In doing so, though, the courts require the government to make the case that the actions that it is stopping or the behavior it is altering are *unreasonable* and that it meets the "rule-of-reason" threshold, i.e., that *there are anticompetitive effects that exceed any pro-competitive effects*.

a. Merger Challenges

- Corporate mergers in the United States, where the transaction value exceeded $111.3 million in 2023, required the acquiring company to file a pre-merger notification with the Justice department, with consummation of the merger happening only after approval.
- In its most recent update to requirements on pre-merger notifications, the DOJ expanded its information disclosure requirements to include transaction-related documents from deal teams and more complete information about both the products and services offered by the companies, as well as about corporate governance.
- In a report that it is required to file under the Hart-Scott-Rodino Act for the 2023 fiscal year, the DOJ listed out the number of merger challenges for the year (16), breaking them down into wins (1), consent agreements (4), ongoing litigation (1) and abandonments/restructured complaints (10).

Most challenged industries



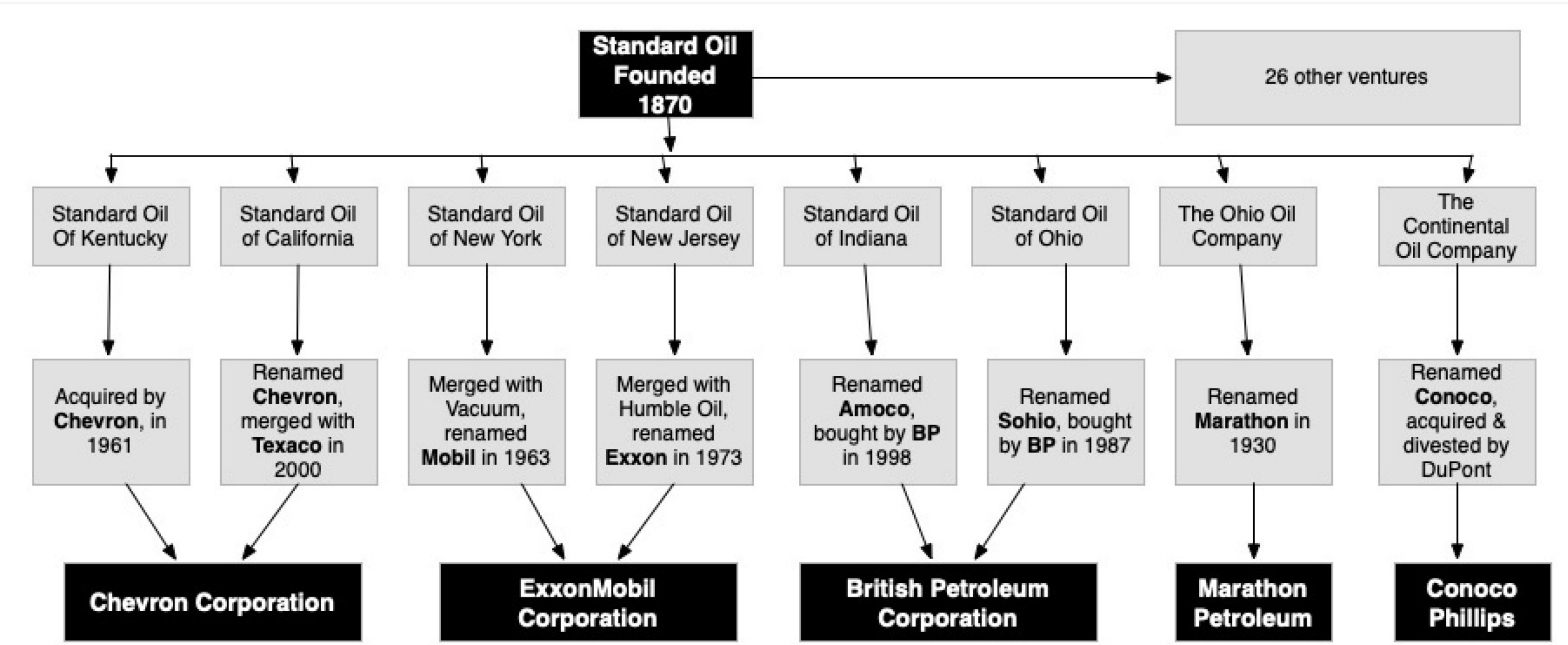
b. Operating changes

- Forced divestitures: As part of a settlement allowing a proposed merger of Vistra Corporation to acquire nuclear plants owned by Energy Harbor Corporation, where the FTC raised concerns about less competition and higher energy prices for consumers, Vistra agreed **to divest** its power plant in Ohio.
- Product bundling/Pricing: As a condition for allowing Amgen to move forward on its acquisition of Horizon Therapeutics, where the FTC feared that Amgen would use its large drug portfolio to pressure pharmacies to push Horizon's two monopoly products, the FTC secured a consent order where Amgen agreed not to condition any of its product pricing or rebates on whether Horizon drugs were prescribed.
- Corporate governance: In EQT's acquisition of Quantum, the FTC's concern was that as these companies were direct competitors, giving EQT a seat on the board and a large shareholding in Quantum would reduce competition. Consequently, EQT was forced to divest its EQT shares and was prohibited from having a board seat.

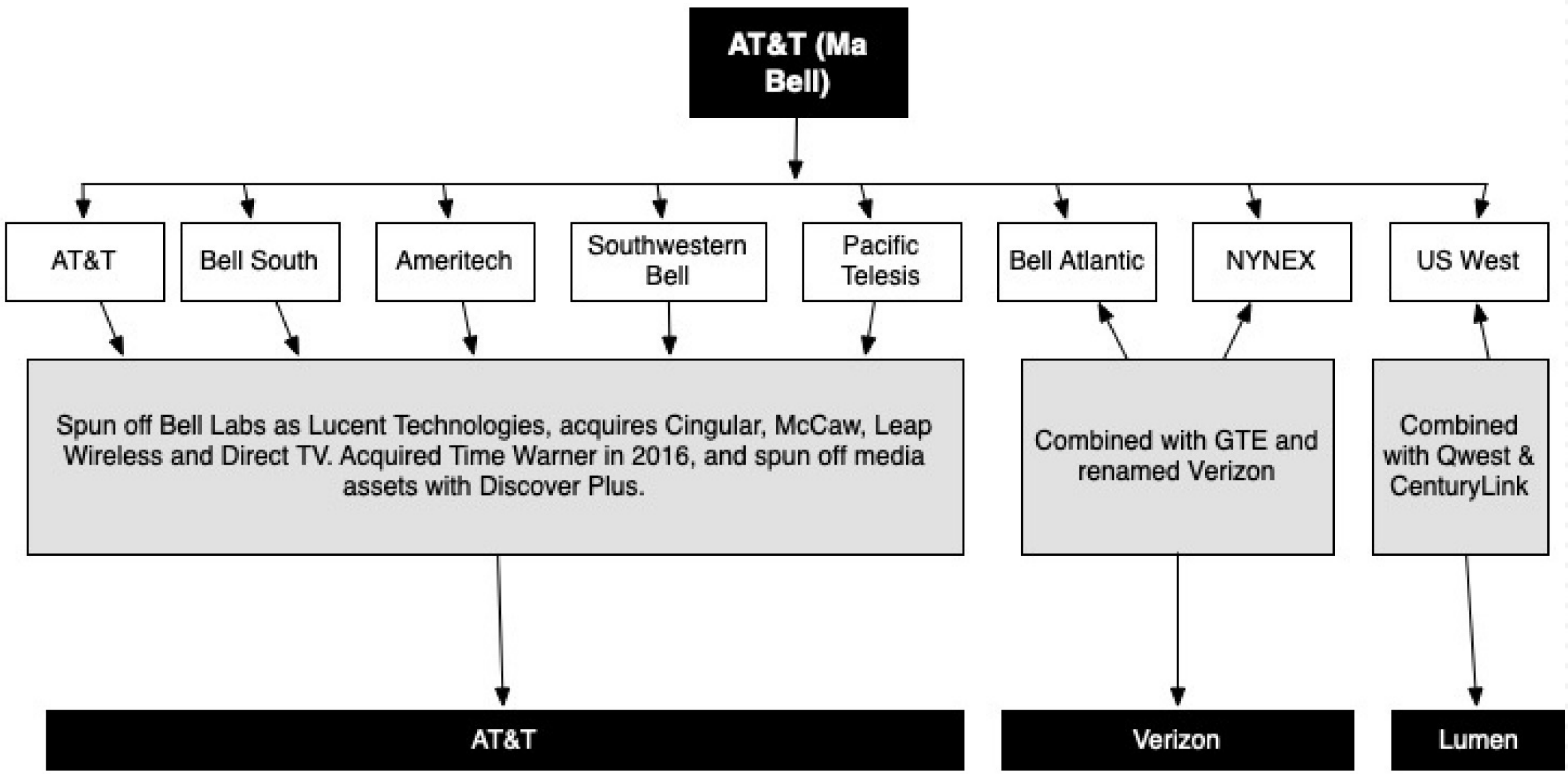
c. Pricing Oversight

- If it is price fixing by a company that has drawn the attention of the antitrust enforcers, it is possible that the remedies sought will reflect changes in the way a company prices its products and services.
  - In 1996, Archer Daniels Midland (ADM) pleaded guilty to fixing prices for Lysine, an animal feed, in collaboration with Japanese and Korean companies. The company, in addition to paying a large fine and having top executives face jail time, was also required to change its pricing processes.
  - In 2024, the FTC published a warning that the use of algorithms by multiple competitors in the same business, to set prices, can violate antitrust laws, and sued RealPage, a property management software, for allegedly allowing landlords to use its algorithms to drive up rental prices.

2. Breaking up – The Standard Oil Breakup (1911)



The AT&T Breakup



The (almost) Microsoft Breakup

- The third breakup, albeit one that did not go through, targeted Microsoft in 2000, where the DOJ sought to break up the company, separating its operating system (Windows) from its application software and browsing businesses (Office and Internet Explorer).
- The courts initially found in the government's favor, but that ruling was subsequently set aside.
- Eventually, the company settled, agreeing to share some of its application programming interface with third-party company, but avoided major restructuring.

3. Regulated Monopoly

- The phone business was still in its nascency, when the Willis Graham Act was passed in 1921, arguing that "(t)here are monopolies which ought to exist in the interest of economy and good service in the public welfare, monopolies which must be promoted instead of being forbidden."
  - That act allowed AT&T, then the leading phone company in the United States, to acquire its mostly troubled competitors to create a monopoly, with a catch. That catch was that the company's pricing power would be regulated to deliver a reasonable rate of return for its investors, thus creating the basis for regulated monopolies.
  - The notion of a natural monopoly was not restricted to just telecommunications, and was used for other utilities, such as water and power, with the only difference being that most of the companies offering those utilities obtained local monopolies rather than national ones.
- Arguably, the decision delivered benefits for customers, as the services were extended to almost every part o the country, albeit at the cost of innovation. As a side benefit, these regulated monopolies, protected from competition, had the capacity use their surplus funds to support activities that had societal benefits, that they would not have in a competitive setting.

The End Game

Anti-trust: Upside and Downside of Acting

Competitors and the Business

Key question
How will the business economics change?
Determinants
a. Business innovation/choice: Does it lead to more or less choice and innovation?
b. Business profitability/health: Is the overall business more or less profitable and healthy?
Bottom line
- In businesses where the economics favor consolidation, forced competition will make worsen business economics, with neither competitors nor consumers benefiting in the long term.
- In businesses, where the economics favor smaller and more players, forced competition will make the business more innovative and efficient.

The Economy and Markets

Key question
Will the economy and market be helped or hurt?
Determinants
a. Economic growth: What impact will it have on the real economy (growth and employment)?
b. Market cap: What impact will it have aggregate market cap
Bottom line
- If the targeted company has cut wages and workforce and faltered in terms of increasing market cap, the anti-trust action will have positive effects.
- If the targeted company has increased employment, delivered real growth and accounted for a large percent of market cap increases, targeting it will have negative effects.

Company & its Investors

Key question
Will the company become more/less valuable?
Determinants
a. Cashflows: How will it affect current revenues and costs?
b. Growth: What effect will it have on future growth potential?
c. Risk: Will it make the company less or more risk?
Bottom line
- If investors trust company management and the company has a track record of delivering value, the anti-trust action will make it less valuable.
- If investors mistrust management and it has faltered on its value creation, the action can make the company more profitable and valuable.

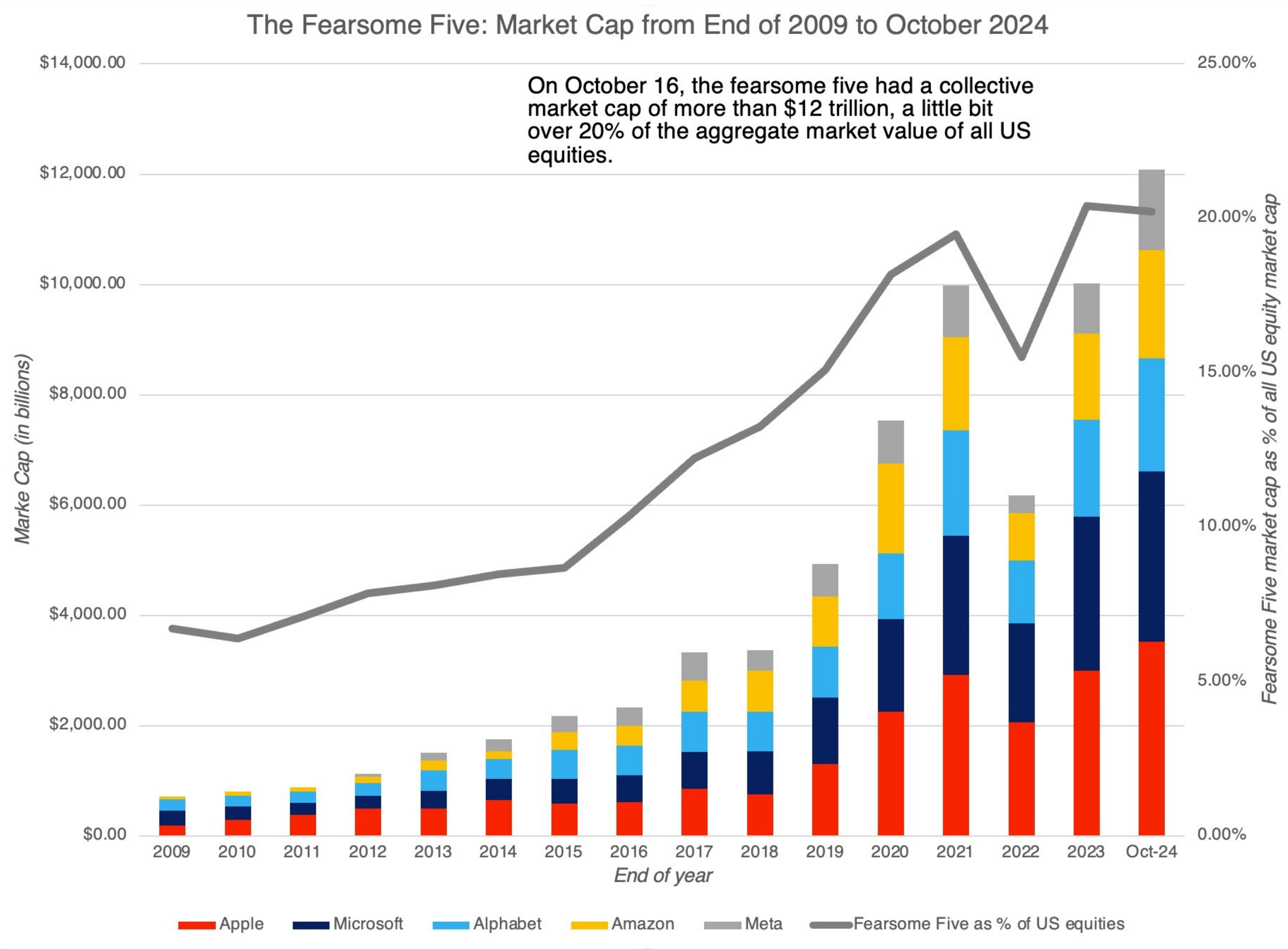
Consumers

Key question
Will consumers be hurt or helped by action?
Determinants
a. Prices: Will product/service prices increase or decrease?
b. Innovation and choice: Will there more or less innovation and choice?
c. Service: Will service improve or deteriorate?
Bottom line
- In dominant companies that fight innovation and charge monopoly prices, consumers will benefit from action.
- In companies, where market dominance has come from offering subsidized products and services to consumers, consumers will have to trade off short term losses (from lost subsidies) against perceived or promised long term gains.

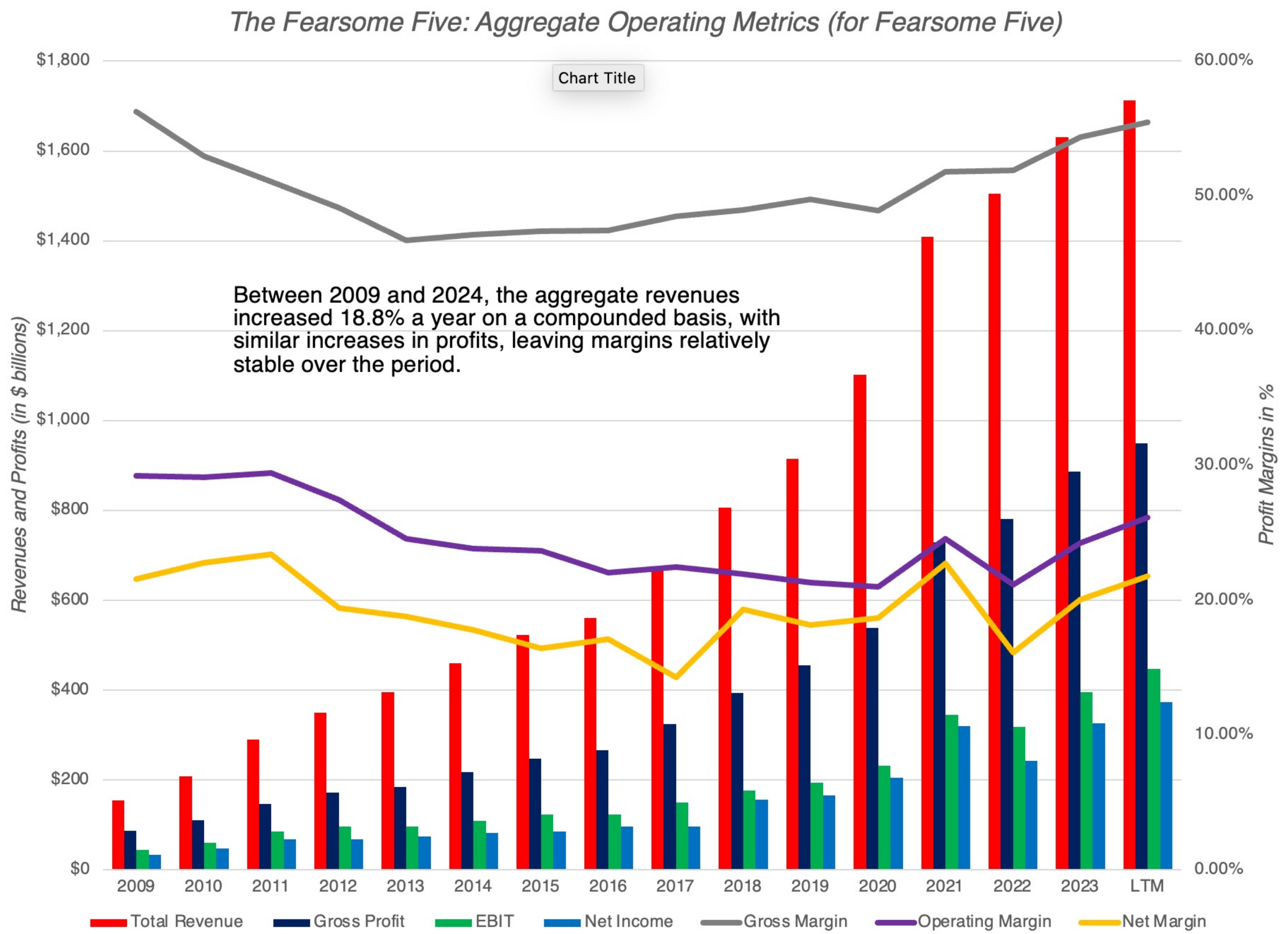
The Big Tech Dilemma

- This session was precipitated by the Justice department’s targeting of Alphabet, with threats of a break-up and requiring the company to share its data.
- While neither threat has been made explicit, it is worthwhile thinking about how the big tech companies measure on the competitiveness scale, and whether antitrust law can or should be used to cut them down to size.
- The challenge, as we will see, is that we all agree that big tech has become perhaps too big, but the question of how it got that big has to be answered before we respond to the bigness.

1. Big tech is big (in market cap)



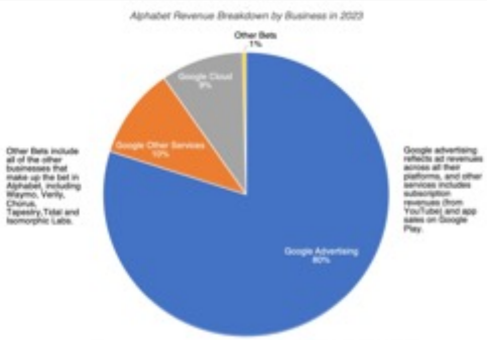
And in operating metrics



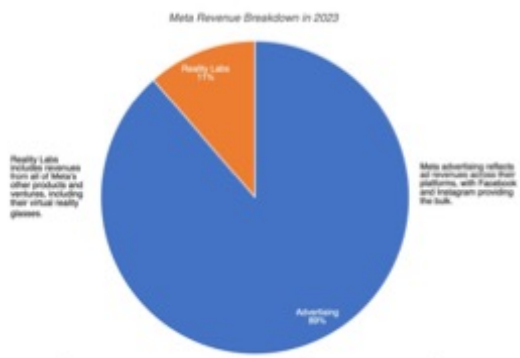
And in day-to-day life

- There is a final component on which you can measure how big these companies have become, and that is to look at how much of our time and lives is spent on one or more of their platforms.
- In a New York Times article from 2020, the writer talked about trying to live without big tech for six weeks, and how difficult she found the consequences to be.
- During the same year, I chronicled in a post how much time I spent each day on the platforms on one or more of the big tech companies, essentially concluding that I was in their grip for all but fifteen minutes of the day.

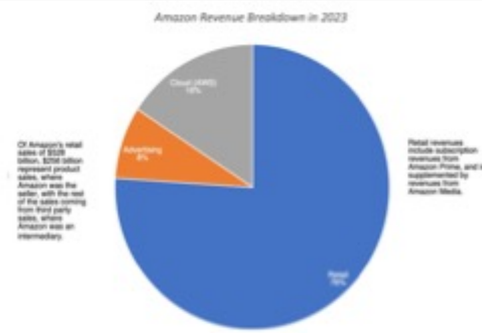
Pathways to Bigness
1. Core Business Dominance



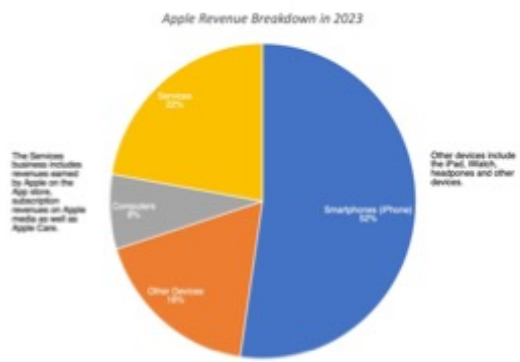
	Revenues	Operating Income
Google Advertising	$224,473	$95,858
Google Other Services	$29,055	
Google Cloud	$26,280	$1,716
Other Bets	$1,068	-$4,095



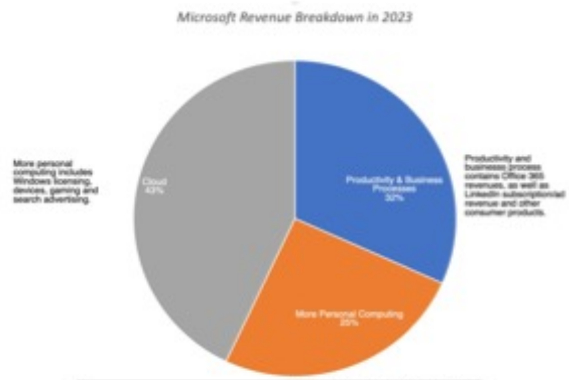
	Revenues	Operating Income
Advertising	$224,473	$42,661
Reality Labs	$29,055	-$13,717



	Revenues	Operating Income
Retail	$437,028	$12,221
Advertising	$47,000	
Cloud (AWS)	$90,757	$24,631



	Revenues	Operating Income
Smartphones (iPhone)	$200,583	$108,803
Other Devices	$68,145	
Computers	$29,357	
Services	$85,200	$60,345



	Revenues	Operating Income
Productivity & Business Processes	$77,728	$40,540
More Personal Computing	$62,032	$19,309
Cloud	$105,362	$49,584

2. Shaky Side Businesses (with one exception)

- Largely funded by cashflows from their core businesses, the big tech companies have tried to enter new businesses, mostly with little to show for their investments.
  - Alphabet has been most open about its ambitions to be in multiple businesses and its renaming was largely a signal of that intent.
  - Amazon's ambitions to be a disruption machine have been widely documented, with forays into logistics, entertainment and even health care.
  - Apple has been more restrained, but it too has tried its hand at entertainment and other businesses.
  - Meta, after facing market backlash for its badly framed entry into the Metaverse, has retooled itself and is trying for success in AI and virtual reality.
- For the most part, these side businesses have been cash drains, and added little in value, with one exception.
  - For three of these companies, Amazon, Alphabet and Microsoft, the *cloud business* has become not only a large part of their revenue base, but also an even bigger contributor to their profitability.
  - With Apple, the services business is offering promise in terms of growth and is a gold mine when it comes to profitability, but it draws much of its value from the iPhone franchise.

3. Consumer Subsidization

- These companies have also created subsidy mechanisms for consumers, offering them products and services that are "free" or "bargains", at least on the surface.
  - Amazon Prime remains one of the best deals in the world for consumers, since for an annual fee of $139, you get free shipping, entertainment and a host of other services. In fact, Amazon makes explicit the cost of the shipping subsidy in its annual reports each year, and it has spent tens of billion each year for the last decade, supporting that service.
  - Alphabet offers a whole range of products, from Google Docs to Google maps, at no explicit cost, and there are hundreds of millions that use WhatsApp around the world, with no monthly charges or fees.
- Apple and Microsoft, befitting their standing as the elder statesmen in this group, have been more stingy about providing free add ons, but they too have sweeteners that they offer, usually in exchange for data from users.

The Unfairness Arguments

1. Subsidize their product offerings: One of the critiques of tech companies is that they use the massive profits they generate from their businesses, core and cloud, to subsidize their product offerings to customers.
2. Networking benefits: Most of these companies have large platforms, and in the businesses that they operate in, that can work in their favor.
3. Use of private data: When users spend their time on the tech company platforms, they are providing data to these companies that can be used to their benefit.
4. Squashing competing technologies: When your platforms become ubiquitous, your competitors might need your permission to play on these platforms, and the big tech companies often make it either more difficult to play or claim a large chunk of revenues.
5. Not paying fair price for content: Many of the big tech platforms allow users to access content for free, with the content developers feeling shortchanged. The big tech companies benefit from this content access, because that access increases platform usage and their revenues (from advertising, device sales etc.), but in a fair system, they should be sharing this revenue with the content developers and providers

The conclusions

1. Hurt competitors, subsidize consumers: As you look at the critique of big tech, it is clear that the damage from big tech company behavior has been felt mostly by competitors. In fact, consumers for the most part have benefited from the subsidies that they have received, and if they are aggrieved about the use of the data that they have shared with the companies, it is unclear how much they have been hurt by that sharing.
2. Current versus Prospective sins: Extending the first point, even the most severe critics of big tech argue that the costs of allowing them to dominate will be in the future, Lina Khan's criticism of Amazon is that while customers benefit right now from Amazon Prime and other freebies, there will be costs they bear in the future that will outweigh the benefits. In particular, she argues that there will be less choice and innovation, because of Amazon's dominance, and that Amazon will eventually become powerful enough to raise prices, and consumers will have nowhere to go. The problem that Ms. Khan and others in her camp will face is that there is nothing in the company's behavior currently that would lead us to extrapolate to those dire endings.

The Choices
1. Break up

- While you can think of the multiple platforms that Alphabet operates as separate, the truth is that the core business is advertising, and whether you are on the Google search box, YouTube or on Android, that business derives its value from keeping users in the Google ecosystem, rather than on independent platforms.
- There is an added reason why breaking either Alphabet or Facebook into individual platforms makes no economic sense. Online advertising is a business with networking benefits, and any solution that pushes you away from consolidation, may create more competition, but will worsen business efficiency and health.
- You can demand that Alphabet be forced to divest itself of all of it non-ad related bets, but very few of these businesses can stand alone. It is true that the cloud businesses have the capacity to stand alone, but what is the argument that you would use for forcing divestiture? After all, in the three companies that have significant cloud businesses - Alphabet, Microsoft and Amazon, their success in the cloud had little or nothing to do with core business domination and divestitures make it less likely that consumers gets subsidized products, which will make them worse off.

2. Regulated Monopoly

- The regulated monopolies of the last century agreed to the pricing restriction quid quo pro because the government gave them monopoly power in the first place. With tech companies, what exactly would the government be offering these companies in return for the loss of pricing power? With Alphabet and Meta, the online advertising market is not the government's to give away, and with smartphone (Apple) and online retail (Amazon), it becomes an even bigger reach.
- If, in fact, the government did get control of pricing power at these companies, who would be the beneficiaries? With online ads, the benefits would flow to the advertisers, a transfer of wealth from one set of companies (the Big Tech advertising companies) to another set of businesses (the many companies that advertise on the tech platforms), and that is neither fair not equitable.
- If the end game is innovation, and with technology, it is the lubricant for success, creating regulated monopolies and requiring them to earn their cost of capital will not only destroy incentives to innovate, but leave these companies exposed to disruptors from other markets.

3a. Targeted actions (that may work)

1. Platform access: If you own a platform where users congregate, you cannot make the roadblocks to third parties being on the platform so onerous that they are put at an almost insurmountable disadvantage. I think that Apple and Alphabet will be pushed to make their platforms more accessible (technically and economically) than they are right now.
2. Paying for content: As AI looms larger, the fight over content ownership will get more intense, since AI can not only be a monstrously large consumer of content, but can do so with little heed to where the content comes from, or who owns it. Content owners and developed may need an assist from the government, when they fight to reclaim the content that belongs to them.
3. Customer and User Recourse: The power dynamics when you use a tech platform are imbalanced, and as a user or customer, you often have no power against the company operating the platform, if it chooses to act against you. As someone who has kept my blog on Google Blogger and my videos on YouTube, there is almost nothing I can do if Alphabet decides to shut them both down, other than appeal to the company and hope to get a fair hearing. Governments may push more formal appeals processes, with independent arbiters, to provide for more balance.

3b. And probably will not…

1. Share data with competitors: It is possible that the government will try to get tech companies to share the data they collect, but I believe that this is neither fair nor a competitive plus. While having the data gives them an advantage over their competitors, that can be said about competitive advantages in many other businesses, and companies in those businesses are not asked to do the equivalent.
2. No cross subsidization: The problem is that cross subsidization is part of almost every large company, where successful, cash-rich portions of the company subsidize cash-poor portions, perhaps with growth potential. Those subsidies can sometimes hurt shareholders of the company, but it is not the DOJ's job to provide them with protection. In fact, the big tech companies have not been immune from investor backlash, as Meta found out, when it pushed its Metaverse investing plans forward with no clear pathway to monetization.
3. Device Compatability: Much as this may frustrate us, as consumers, no company should be obligated to make it easier for competitors to take business away, and government attempts to suggest otherwise will be heavy handed and ineffective.

4. Do nothing

- Tech life cycles are short: Tech companies age in dog years, scaling up much faster, not lasting at the top as long and declining much more quickly than non-tech companies.
- As an extension of the first point, if innovation costs money, and life cycles are short, companies have to be allowed to make money during their brief stints at the top, to justify innovation.
- To the extent that big tech companies are tempted to play it safe, cutting back on innovation and using their market power to increase prices on customers, i.e., the Lina Khan doomsday scenario, they expose themselves to disruption far more than manufacturing or consumer product companies do.

Conclusion

- It is clear that I do not see eye to eye with Lina Khan, but I will start with the presumption that she has good intentions and that her argument is deeply thought through.
- My concerns with her big tech views are two-fold. The first is that she is a lawyer, and law schools around the world do an awful job on teaching their graduates about business. The second is that she is a true believer, and if you start with the view that big tech companies are evil, you will undoubtedly find good reasons to cut them down to size.
- I do recognize that there are non-economic considerations at play, and that you may fear the effect that big tech platforms are having on our politics and social discourse. I share that concern, but I am not sure that there is an economic solution to that problem
- If you think that breaking up Google and Meta will lead to more polite discourse on social media and a return to the cultural norms of yesteryear, you are being naive, since the problem lies not in Twitter, Facebook or Reddit, but in ourselves. I am afraid that we have opened Pandora's box, and there is no shutting it now!