Antitrust in the Internet Age

Illustration: Robert Neubecker, The Wall Street Journal

To commemorate the 29th anniversary of the World Wide Web, on March 12th, Sir Tim Berners-Lee – an internet pioneer who created the Web and was named by Time Magazine to its list of the 100 Most Important People of the 20th Century[1] – published an open letter that sharply rebuked today's largest internet and technology companies for their concentration of power, anti-competitive behavior and role in enabling the spread of misinformation.[2] In an interview with the Financial Times following the release of his letter, Sir Tim called for a "new legal or regulatory framework [that] may help to limit the power of big tech companies, which [have] become overly-dominant and unaccountable to ordinary users."[3] Both in the U.S. and abroad, there seems to be a growing concern over the power of today's dominant technology companies and what, if anything, can be done to keep them in check. In this letter we discuss the existing legal framework under which technology firms operate and how potentially new regulatory measures may impact their businesses. Additionally, we analyze the demand-driven network effects that make these companies so powerful and how investors can benefit from seeking to gain exposure to growing, platform-based firms outside of large-cap tech stocks.

For investors in today's leading technology and internet firms, the threat of heightened regulation is one that merits increasing attention. In the European Union, competition commissioner Margrethe Vestager has taken an aggressive approach to investigating U.S. technology companies such as Apple and Alphabet (parent company of Google), initiating probes and levying fines for alleged violations of E.U. tax and antitrust laws.[4] The E.U. is also contemplating a 3% tax on technology companies' revenues (not profits) based on the location of their users. Furthermore, on May 25th, Eurozone countries will begin enforcing the new General Data Protection Regulation, which gives E.U. citizens the right to have their personal data be forgotten.[5] This is an especially difficult regulatory development not only because the E.U. may fine companies up to 4% of their total annual revenues for non-compliance, but also because the accumulation of user data is what makes tech companies like Facebook, Google and Amazon such powerful and effective platforms.

Developments in the U.S. should also give investors some pause. In the aftermath of Russian attempts to interfere in the 2016 election and the continuing lack of full transparency from several tech companies in response to congressional inquiries, bipartisan consensus is emerging in support of increased oversight of large, internet businesses – particularly, Facebook, Google and Twitter. Facebook continues to find itself under particularly harsh scrutiny. The revelation from New York Times reporters on March 17th that the firm Cambridge Analytica – which assisted the Trump campaign's digital efforts – used a feature once available to Facebook app developers to collect

Securities offered through Western International Securities, Inc. (Western), Member FINRA and SIPC, and Fidelity Brokerage Services LLC (Fidelity), Member NYSE, SIPC. Karmin Capital, a division of Fort Sheridan Advisors LLC, Western and Fidelity are separate and unaffiliated entities.

detailed personal data on approximately 50 million users without the vast majority of their consent has quickly drawn widespread condemnation.[6] Democratic Senator Amy Klobuchar, of Minnesota, and Republican Senator Marco Rubio, of Florida, have already publicly criticized the company, calling for Mark Zuckerberg to testify before Congress and hinting at potential regulation if the site cannot adequately police itself and protect user data.[7] Apart from Facebook's issues, regulation of technology companies more broadly is gaining prominence in political party platforms. In December, Keith Ellison, the co-chairman of the Democratic National Committee, introduced the 21st Century Competition Commission Act, to address corporate monopoly power and its anti-competitive effects. And on the Republican side of the aisle, several politicians are endorsing anti-tech measure, such as Josh Hawley – a U.S. Senate candidate who, as Missouri's attorney-general, launched an antitrust investigation into Google.[8]

Clearly there has been a marked shift in sentiment toward these firms compared to several years ago. Today, big tech companies seem to find themselves under popular attack for everything from the outcome of the 2016 election, the dearth of new private business formation, the demise of traditional media and retailers, unfair tax avoidance and blue-collar job losses. Whether this is fair largely depends on one's personal views; whether the regulatory threat is realistic depends on current and potential laws. As the companies under scrutiny are all U.S. domiciled, the following analysis will focus primarily on the U.S. legal regime. However, as technology and internet companies are global businesses, local laws and regulations – especially those in the E.U. – will play an increasingly important role in shaping the future business environment for these firms.

* * * * *

Free choice is the bedrock of capitalism. In a free society, consumers can freely express their preferences by buying whatever goods they prefer and using whatever services they find to be most beneficial. Free choice breeds competition and spurs technological innovation. In turn, competition and innovation drive the economy forward, creating new opportunities, keeping the price of goods and services from quickly rising and improving living standards. When free choice and competition break down, innovation stagnates, economies lose their dynamism and living standards deteriorate.

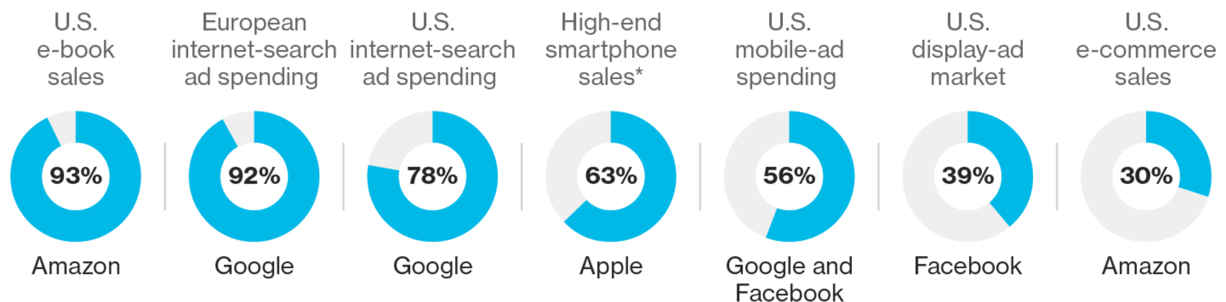
Accordingly, antitrust law – the enforcement mechanism by which capitalist societies ensure their economic dynamism – is premised on the protection of free choice.[9] Specifically, U.S. antitrust laws – which have emerged from the Sherman Act of 1890, the Clayton Act of 1914 and the Federal Trade Commission Act of 1914 – work to accomplish several main objectives, all aimed at promoting consumer welfare and free markets: (1) preventing unlawful mergers that are detrimental to competition, (2) prohibiting the creation of monopolies and the abuse of monopoly power and (3) preventing anticompetitive business practices, such as collusion, cartel formation and price fixing.[10] As an aside, European antitrust law is more concerned on protecting competition than consumer welfare (with a strong presumption of unlawful, anticompetitive behavior in the case that a monopoly exists).

The most glaring examples of U.S. antitrust violations are when two primary competitors in an industry merge, competing businesses within one industry collude to raise prices or when one company works to centralize an entire industry supply chain. John Rockefeller's Standard Oil is the classic example of antitrust violations (although scholars have recently cast skepticism on the degree to which the company abused its market power). The

Securities offered through Western International Securities, Inc. (Western), Member FINRA and SIPC, and Fidelity Brokerage Services LLC (Fidelity), Member NYSE, SIPC. Karmin Capital, a division of Fort Sheridan Advisors LLC, Western and Fidelity are separate and unaffiliated entities.

traditional account of the company's abusive actions is as follows: in the late 19th and early 20th Centuries, Standard Oil expanded by purchasing competitors and using its clout to pressure service providers (like railroads) to provide the company discounts unavailable to smaller competitors. Where the company faced competition, it used its size to price competitors out of the market; and in markets without competitors, the company raised final prices to end-consumers, taking advantage of the lack of competition. Through a series of partnerships and trusts, Standard Oil gained control of nearly the entire U.S. oil supply chain – including production, refining, distribution and marketing. By 1904, the company controlled 91% of U.S. oil production and 85% of final sales. On May 15, 1911, the U.S. Supreme Court affirmed a lower court decision that found the Standard Oil group to be an "unreasonable" monopoly under the Sherman Act. The Court ordered the company to break up into 34 independent firms with different management and directors. For those interested in the history of the U.S. oil industry, the largest two of these companies were Standard Oil of New Jersey (which later became Exxon) and Standard Oil of New York (which later became Mobil). Ironically, after the breakup of the company (of which John Rockefeller owned approximately 25%), the value of the new companies doubled – propelling Mr. Rockefeller's wealth to the largest in the world.[11]

Antitrust law in the U.S., as it exists today, does a good job of regulating abuses of supply, such as control of oil production, electricity transmission and distribution and access to telecom lines. **What antitrust law does not do – nor what it ever was intended to do – is regulate demand.** Contrary to powerful companies of the past, many of today's largest technology and internet firms have grown to be hugely successful not because they have aggregated supply, but rather because they have benefited from the aggregation of consumer demand.[12] Facebook, Apple, Amazon, Netflix and Google (referred to sometimes as FAANG) did not engage in abusive or anticompetitive practices to corner an entire industry supply chain; on the contrary, they created superior products and services – initially competing in hyper-competitive markets – that have won the loyalty of millions, and in some cases, billions of users. To the extent that these companies do have monopoly power, they are natural monopolies – and they fought hard, but fairly, to become so. Moreover, today's leading technology firms are the very type of free-market success stories that U.S. antitrust law seeks to enable. So long as they do not abuse their market power, U.S. antitrust law has no measures by which to punish them.



Securities offered through Western International Securities, Inc. (Western), Member FINRA and SIPC, and Fidelity Brokerage Services LLC (Fidelity), Member NYSE, SIPC. Karmin Capital, a division of Fort Sheridan Advisors LLC, Western and Fidelity are separate and unaffiliated entities.

Internet-based businesses particularly lend themselves to winner-take-all markets. Where businesses create frictionless markets, intelligently matching the distribution of content, goods or advertisements to their network's users, the winner-take-all effect is especially pronounced. As technology business analyst Ben Thompson of Stratechery notes: "in a world with zero distribution costs and zero transaction costs; consumers are attracted to an aggregator through the delivery of a superior experience, which attracts … suppliers, which improves the experience and thus attracts more consumers."[13] This virtuous cycle leads to the big getting bigger – particularly in markets where an increasing amount of user data enables a company to offer increasingly better, broader and more targeted services. Markets defined by demand aggregation ultimately have huge competitive barriers to entry due to network effects. Take, Google for instance, in the internet search market: the more consumers who use Google's search engine (and other services such as Gmail and Google Maps), the more attractive Google becomes to advertisers. Google can then use advertising revenue and the data its users generate to attract more consumers and advertisers, as well as to improve its search algorithms. While alternative search engines are, as Google notes, "just one click away," the reality is that consumers are intelligent and will self-select into using the best service. To critique Google for its market power would, as Mr. Thompson again notes, be "treating people like dummies, assuming they can't figure out how to find a competitive service, when in fact the truth is they don't want to."[14] Any regulatory demand for an alternative competitive choice, would in fact be demanding an inferior product.

Fortunately, U.S. antitrust officials seem to have a better understanding of digital, competitive market dynamics than their European brethren – who are focused on protecting competition for the sake of competition only. In a February speech in Brussels, the new head of the U.S. Justice Department's antitrust division, Makan Delrahim, remarked: "Where there is no demonstrable harm to consumers, we are reluctant to impose special duties on digital platforms… [The E.U.] stance might stifle the very innovation that has created dynamic competition for the benefit of consumers."[15] However, as noted above, this does not mean that dominant U.S. tech businesses will escape a potentially costly regulatory and social backlash. A company's legal protections are only as strong as the laws that protect it; and, as John Rockefeller might have attested, Congress has a history of passing new and surprising laws that can be disruptive to the business status quo.

In all likelihood, today's leading technology companies – especially those that benefit from the aggregation of user data (Facebook, Google, Twitter and, to a lesser extent, Amazon, Apple and Netflix) – will face some form of federal regulation in the future regarding data privacy and security. It strikes us as reasonable to hold these companies to a high standard of fidelity given the amount of personal data they collect from their users and the immense value of that data – not only to their business operations, but also to potentially malevolent actors seeking to gain access to it. While unlikely in the near future given the stance of the current Justice Department, if antitrust officials ever conceive of personal data as "the new oil" – a tangible object of limited supply – it is possible antitrust law could evolve to regulate abuses of data concentration. Under this vein of reasoning, Facebook should never have been permitted to purchase Instagram in 2012. The combination of two popular demand aggregators that benefit from the collection of user data created a dominant force in digital advertising (that, together with Google, account for 99% of digital ad growth in the U.S.)[16] and has nearly foreclosed all competition in social networking. The recent struggles of Snap Inc. exemplify the difficulty of an upstart gaining traction in a winner-take-all market.

Securities offered through Western International Securities, Inc. (Western), Member FINRA and SIPC, and Fidelity Brokerage Services LLC (Fidelity), Member NYSE, SIPC. Karmin Capital, a division of Fort Sheridan Advisors LLC, Western and Fidelity are separate and unaffiliated entities.

Perhaps of greatest long-term concern to these companies is user dissatisfaction and defection from their services. If today's dominant tech firms lack the discipline or motivation to self-police and improve their platforms, or the sensitivity to recognize that they operate in societies with values that may differ from company goals, user defection will ultimately undermine their businesses. Successful demand aggregators can work to comply with regulatory changes (even if costly), however they cannot easily remedy the loss of users and user data. In this case, the virtuous cycle described above reverses and could become a death spiral (MySpace is a cautionary example). While we are monitoring regulatory developments and tracking political headwinds, we are still generally constructive on these technology companies as investments. However, we are paying close attention to evolving discussions on regulation and any drop-offs in user engagement, such as Facebook's first reported decline in U.S. and Canadian users in the fourth quarter of 2017.[17]

Natural monopolies are rare and amongst the best businesses to invest in, as they are largely insulated from competition. Even more lucrative are natural monopolies (as well as dominant businesses in highly concentrated markets) that operate platform services or networks. Platform businesses generally have huge fixed costs (for instance, computing infrastructure or merchandise fulfillment centers), but nearly zero marginal costs. When the cost of serving more users and generating additional revenue approaches $0, a company's profit margins have nowhere to go but up. The larger these businesses grow, the more they can invest in additional infrastructure and research to improve their services, fend off potential competitors and continue driving users to their platforms. It is no wonder that the largest spenders on research and development are largely technology firms that have dominant platform businesses. As a result, in the markets that these platform businesses dominate, it is exceedingly difficult, if not impossible, for new entrants to come up with the capital to build a meaningful competitive alternative.

Top 10 Spenders on Research and Development in the S&P 500[18]

Company	Industry	R&D Expense (T12M in Billions)	Revenue (T12M in Billions)	Market Cap (Billions)
Amazon.com Inc	Internet	$ 22.62	$ 177.87	$ 745.79
Alphabet Inc	Internet	$ 16.63	$ 110.86	$ 762.55
Microsoft Corp	Software	$ 13.95	$ 102.27	$ 711.85
Intel Corp	Semiconductors	$ 13.10	$ 62.76	$ 235.66
Apple Inc	Computers	$ 12.12	$ 238.54	$ 886.63
Johnson & Johnson	Pharmaceuticals	$ 10.55	$ 76.45	$ 348.72
Merck & Co Inc	Pharmaceuticals	$ 9.98	$ 40.12	$ 146.92
Facebook Inc	Internet	$ 7.75	$ 40.65	$ 507.46
Pfizer Inc	Pharmaceuticals	$ 7.66	$ 52.55	$ 216.27
Bristol-Myers Squibb Co	Pharmaceuticals	$ 6.41	$ 20.78	$ 107.07

Short of a major regulatory threat or widespread user dissatisfaction, today's dominant technology and internet firms are likely to remain entrenched in their leadership positions. As investors, we do anticipate that new regulatory compliance costs will eat into these companies' profit margins over time (particularly for Facebook and Google, which will need to spend more on content oversight and data security). However, we doubt such costs will prove fatal to their monopoly power or long-term earnings power. Rather, if U.S. lawmakers or the E.U. impose costly regulations, it will likely further entrench these companies as market leaders. If smaller competitors lack the

Securities offered through Western International Securities, Inc. (Western), Member FINRA and SIPC, and Fidelity Brokerage Services LLC (Fidelity), Member NYSE, SIPC. Karmin Capital, a division of Fort Sheridan Advisors LLC, Western and Fidelity are separate and unaffiliated entities.

capital to build out a competitive service, they surely lack the capital to comply with new (and likely complex) regulations. In the meantime, though, any hint of harsher regulation will likely pressure the stock prices of these firms: indeed, as we are preparing to circulate this letter, Facebook is down over 7% on concerns over the regulatory fallout of its Cambridge Analytica debacle.[19]

Another takeaway is that investors should seek to find and invest in platform companies in the making. By the time a platform company reaches dominant industry status, much of its stock price appreciation will likely have already occurred. It will be far more difficult for today's leading technology firms to grow from close to $1 trillion valuations to $2 trillion, than for an upstart platform business to grow from a $5 billion valuation to $10 billion. For this reason, we are focused on finding small and mid-cap companies seeking to build out platform businesses in industries ranging from enterprise IT to genetic-based therapies. New platform-based computing solutions (such as hybrid-cloud computing data management) and genetic therapy approaches that can theoretically be applied to thousands of genetic ailments (such as CRISPR) – while risky in their infancy – likely offer investors far greater rewards than today's tech platform giants should these businesses mature to become the dominant platform solutions in their respective fields. As technological change accelerates, we anticipate there will be numerous opportunities to invest in potentially new and groundbreaking business models. Accordingly, we are spending increasingly more time tracking technological and scientific developments.

To tie this all back to the concerns of Sir Tim Berners-Lee, businesses often moves faster than the regulatory environments under which they operate. At question is whether today's dominant technology firms must adapt to existing social and legal norms or whether society and laws must adapt to new ways of doing business. Based on history, our money would be on the former outcome. For that reason, the long-term success of these firms, in part, depends on whether society's response will be punitive or constructive. In this instance, we'd bet on the latter. The reality is that users largely enjoy these companies' services and initially turned to them not for a lack of alternatives, but because they were so far superior to any alternatives. Antitrust law in the U.S. has never been about punishing success; rather, it exists to enable it. Accordingly, since antitrust law is not the appropriate avenue for regulatory action, Sir Tim is right that a new legal framework is likely necessary to regulate these companies. Short of requiring their dissolution – which we view as far-fetched – regulation will not be the death knell of these businesses. Better protecting user data will be a costly challenge; however, that pales in comparison to the difficulty of aggregating consumer demand in the first place. The future regulatory environment will be difficult to navigate for both technology firms and their investors. Rather than bemoan that fact, it is far more productive to prepare for it.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

---

[1] Time Magazine, TIME 100 Persons of The Century (June 6, 1999).
[2] World Wide Web Foundation, *The web is under threat. Join us and fight for it* (March 12, 2018).
[3] Financial Times, *Tim Berners-Lee hits out at big tech companies* (March 12, 2018).
[4] recode, *No one quite polices — and penalizes — tech giants like Europe's watchdog Margrethe Vestager* (Dec. 6, 2017).
[5] Bloomberg, *Tech Giants Set to Face 3% Tax on Revenue* Under New EU Plan (March 17, 2018).

Securities offered through Western International Securities, Inc. (Western), Member FINRA and SIPC, and Fidelity Brokerage Services LLC (Fidelity), Member NYSE, SIPC. Karmin Capital, a division of Fort Sheridan Advisors LLC, Western and Fidelity are separate and unaffiliated entities.

---

[6] The New York Times, *How Trump Consultants Exploited the Facebook Data of Millions* (March 17, 2018).
[7] The Washington Post, *U.S. and British lawmakers demand answers from Facebook chief executive Mark Zuckerberg* (March 18, 2018); Business Insider, *Marco Rubio throws Facebook under the bus for allowing Trump-linked firm to take 50 million users' information in massive data 'breach'* (March 18, 2018).
[8] Financial Times, *Big Tech's trust issues at the forefront of Davos debate* (Jan. 21, 2018); The New York Times, *Tech Giants Brace for Europe's New Data Privacy Rules* (Jan. 28, 2018).
[9] U.S. Federal Trade Commission, *Guide to Antitrust Laws* (available at: https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws). In fact, the first line of the U.S. Federal Trade Commission's "Guide to Antitrust" notes that, "Free and open markets are the foundation of a vibrant economy."
[10] U.S. Federal Trade Commission, *Guide to Antitrust Laws* (available at: https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws); Cornell Law School, Legal Information Institute, *Antitrust* (available at: https://www.law.cornell.edu/wex/antitrust).
[11] Wikipedia, *Standard Oil;* New York Times, May 15, 1911 | Supreme Court Orders Standard Oil to Be Broken Up (May 15, 2012).
[12] For a superb discussion of the aggregation of consumer demand and what implications that has for businesses, generally, and antitrust law, refer to the writing of technology business analyst Ben Thompson at www.Stratechery.com (the $100 annual subscription is well worth the cost).
[13] Stratechery, *Ends, Means and Antitrust* (June 28, 2017).
[14] Stratechery, *Ends, Means and Antitrust* (June 28, 2017).
[15] Bloomberg, *Trump Antitrust Cop Splits With EU Over Probes of Big Tech* (Feb. 21, 2018).
[16] Business Insider, *Facebook and Google completely dominate the digital ad industry* (April 26, 2017).
[17] BCA Research, *Technology Sector Strategy*) March 6, 2018).
[18] Bloomberg (as of March 18, 2018).
[19] Bloomberg (as of 2:20 PM Central Time on March 19, 2018).

Investing involves risks, including the possible loss of principal and fluctuation of value. Past performance is no guarantee of future results.

This letter is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of the date noted above and may change as subsequent conditions vary. The information and opinions contained in this letter are derived from proprietary and nonproprietary sources deemed by Karmin Capital to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. As such, no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by Karmin Capital, its principals, employees, agents or affiliates, or by Fort Sheridan Advisors LLC, its principals, employees, agents or affiliates. This post may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will materialize. Reliance upon information in this post is at the sole discretion of the reader.

Please consult with your Karmin Capital financial advisor to ensure that any contemplated transaction in any securities mentioned in this letter align with your overall investment goals, objectives and tolerance for risk. In addition, please note that Fort Sheridan Advisors LLC, through its wealth management division, Karmin Capital, including its principals, employees, agents, affiliates and advisory clients, may have positions in one or more of the securities discussed in this communication. Please note that Karmin Capital, including its principals, employees, agents, affiliates and advisory clients may take positions or effect transactions contrary to the views expressed in this communication based upon individual or firm circumstances. Any decision to effect transactions in the securities discussed within this communication should be balanced against the potential conflict of interest that Karmin Capital has by virtue of its investment in one or more of these securities.

Additional information about Fort Sheridan Advisors LLC is available in its current disclosure documents, Form ADV and Form ADV Part 2A Brochure, both which are available without charge by contacting Fort Sheridan toll-free at 866-559-9700. You may also request copies by email at info@fortllc.com, or access the documents online via the SEC's Investment Adviser Public Disclosure (IAPD) database at www.adviserinfo.sec.gov, using CRD# 151139 or SEC# 801-70517.

Karmin Capital neither provides investment banking services nor engages in principal or agency cross transactions. Karmin Capital is the wealth management division of Fort Sheridan Advisors LLC. All securities transactions are effected through Western International Securities, Inc. and Fidelity Brokerage Services LLC. Fort Sheridan Advisors LLC is not an affiliate of Western International Securities, Inc. or Fidelity Brokerage Services LLC.