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The Platform Competition and Opportunity Act Is a Solution in Search of a Problem

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The killer acquisitions that Congress seeks to prevent are rare and less likely to occur in technology markets. The proposed legislation will harm an important incentive for start-up innovation and deny consumers the benefits of pro-competitive acquisitions.

KEY TAKEAWAYS

- For start-ups engaged in incremental innovation, an exit strategy that involves being acquired can be more profitable than head-to-head competition. This difference in the return to innovation is a key driver of innovation incentives for start-ups.
- Killer acquisitions should only be expected when start-ups are engaged in radical innovation that displaces incumbent firms, such as in pharmaceuticals.
- We should not expect killer acquisitions to be pervasive in technology markets where innovation tends to be cumulative and builds on the prior innovation of incumbent firms.
- Large tech platforms, merely due to their size and market, will face a more burdensome standard for merger review. In theory, the bill's presumptions of illegality are rebuttable, but in practice the burden of proof is likely to be insurmountable.
- Current merger-review procedures are adequate to identify potential killer acquisitions, provided the proposed transactions are reported to antitrust agencies.
- Instead of imposing a sweeping change to merger enforcement based on firm size, Congress should consider more narrowly tailored interventions such as reducing the merger-reporting thresholds.

INTRODUCTION

The Platform Competition and Opportunity Act (PCOA), introduced last November by Sens. Cotton (R-AR) and Klobuchar (D-MN), would outlaw all but the smallest acquisitions by large technology platforms.[1] The PCOA creates a narrowly tailored "covered platform" designation based on sales, capitalization, and user thresholds to target specific platforms—Amazon, Apple, Google, Meta, and Microsoft—while excluding large competitors to these platforms such as Walmart whose market capitalization falls just below the threshold. The PCOA would prevent acquisitions by covered platforms unless the platform can demonstrate that it is not acquiring a direct, nascent, or potential competitor, enhancing a market position, or enhancing its ability to maintain a market position. Senators Cotton and Klobuchar introduced this legislation, "to prevent monopolistic big tech firms from making killer acquisitions that harm competition and eliminate consumer choice."[2] In support of the legislation, Rep. Cicilline (D-RI) stated that it, "will stop harmful transactions and spur innovation, promote a more vibrant start-up ecosystem, and give consumers more choice."[3]

While the stated intent of the PCOA is to prevent so-called "killer acquisitions" and spur innovation, the bill's sponsors overlook the role of acquisitions as an innovation-enhancing start-up exit strategy. The PCOA is a solution in search of a problem as killer acquisitions are rare and less likely to occur in the technology markets Congress seeks to regulate. The legislation will be ineffective at preventing killer acquisitions by covered platforms as the values for transactions characterized as killer acquisitions are typically below the threshold the PCOA would establish. The burden-shifting requirements of the legislation, however, will effectively prevent covered platforms from making any acquisitions above the PCOA threshold thereby reducing consumer choice and starving innovators of an important funding source. In lieu of transforming long-accepted merger review standards based on the rule of reason into per se liability standards based on firm size, Congress should consider more tailored interventions such as changing merger pre-notification thresholds while supporting a rule of reason approach to merger review.

ACQUISITION IS AN INNOVATION-ENHANCING START-UP EXIT STRATEGY

Incentives for innovation are complex. The PCOA harms the start-ups and small businesses that legislators are professing to protect by reducing their incentives to innovate. Acquisitions of small firms by large firms enhance incentives for innovation. Some innovations are radical and disruptive and the firms developing these innovations tend to displace incumbent firms. Amazon's innovations in retailing fit this category. Amazon has nearly displaced Walmart as the leading U.S. retailer.[4] However, some innovations are incremental and build on the prior innovations of incumbent firms. For example, Waze's innovation in crowd-sourcing traffic information builds on Google's innovations with respect to Google Maps. For incremental innovators, a start-up exit strategy that involves being acquired by an incumbent firm is often more profitable than head-to-head competition with the incumbent firm. This difference in the return to innovation is a key driver of innovation incentives for start-ups.[5] The PCOA would undermine this incentive.

A recent study by the Federal Trade Commission (FTC) suggests that acquisition by large technology platforms is an important exit strategy for start-ups. The FTC examined acquisitions by Amazon, Apple, Facebook, Google, and Microsoft that were not reportable to the antitrust agencies under the Hart-Scott-Rodino (HSR) Act. A key metric in the FTC study is the age of the acquired firm at the time of the acquisition. Startups are venture-backed, disruptive, high growth firms and are typically five to 10 years old when they exit their venture-backing either through an initial public offering or through an acquisition.[6] In more than two-thirds of the transactions the FTC studied, the acquired firm was less than 10 years old at the time of the acquisition.[7] That is, an overwhelming majority of the non-reportable acquisitions by large technology platforms were very likely of start-ups. That these start-ups chose to be acquired rather than compete head-to-head with incumbents reveals that acquisition was a more profitable exit strategy. This is certainly true of Keyhole, an early mapping start-up, whose acquisition by Google allowed them, "to scale and expand [mapping] functionality by orders of magnitude more than they could envision when they first started."[8]

The importance of acquisitions for innovation incentives is not merely the product of economic theorizing as start-up entrepreneurs themselves recognize the importance of acquisition as an innovation incentive. In a recent Senate Judiciary Committee hearing, Bettina Hein, a serial entrepreneur, testified that acquisitions, "enable start-up investors to reclaim their invested capital, realize any gains, and recycle their capital into the next generation of start-ups, fueling the ongoing process of innovation-led economic growth and job creation."[9] The PCOA would interrupt this virtuous cycle of innovation and economic growth.

EVIDENCE OF ANTICOMPETITIVE EFFECT IS LIMITED

There is no evidence that killer acquisitions targeted by the PCOA are pervasive.[10] Colleen Cunningham and her co-authors introduced the term, "killer acquisitions," to reference certain types of acquisitions they identify in their study of the pharmaceutical industry.[11] Their study examines how an acquisition impacts a drug project's development with a particular focus on how the impact may differ when the acquirer has a substitute drug for the acquired drug project. A killer acquisition takes place when an acquirer with a substitute drug ceases the development of the acquired drug following the acquisition. Cunningham and her co-authors estimate that only 5 to 7 percent of the acquisitions they study are killer acquisitions. Their study demonstrates that killer acquisitions are not pervasive in the pharmaceutical industry.

The limited evidence of killer acquisitions in the pharmaceutical industry does not suggest that we should expect killer acquisitions in technology markets. If anything, we should expect to see fewer killer acquisitions than in the pharmaceutical industry. The pharmaceutical industry is best characterized by radical innovation. Pharmaceutical innovation is intended to displace incumbent firms. Innovation in technology markets tends to be incremental or cumulative and builds on the prior innovations of incumbent firms. Alberto Galasso and Mark Schankerman find that patent invalidation has a significant effect on cumulative innovation in computers, communications, and electronics industries and no effect on cumulative innovation in pharmaceuticals consistent with the different types of innovation in these industries.[12] If there is no threat of displacement, as would appear to be the case in many technology industries, there can be no killer acquisitions.

The proposed bill is a solution in search of problem with the unintended consequence of harming consumers and innovation. Not only do acquisitions provide innovation incentives to start-ups but they also create synergies that benefit consumers. Facebook's acquisition of Instagram provides one example of these synergies. By combining data on users across their platforms, Facebook can better target advertising. As a result, consumers see more relevant ads and ads are more cost effective for advertisers who pass their cost savings onto the consumers of their products.[13] The PCOA would prevent firms from realizing these pro-competitive synergies.

ACQUISITIONS SHOULD BE EVALUATED USING THE RULE OF REASON INSTEAD OF SIZE-BASED TESTS

To the extent killer acquisitions are taking place in technology markets, the PCOA will not stop them. Cunningham and her co-authors find that transaction values for acquisitions of drug projects for which the acquirer has a substitute drug (i.e., potential killer acquisitions) are bunched just below the HSR-reporting threshold.[14] The PCOA exempts transactions valued at less than $50 million. While the bill's provisions will apply to some previously non-reportable transactions, the vast majority of non-reportable transactions by large technology platforms are valued at less than $50 million. The FTC study on acquisitions by large technology platforms shows that 93 percent of the non-reportable transactions were valued at less than $50 million.[15] The PCOA will capture few transactions that are not already captured by current HSR-reporting thresholds because less than seven percent of non-reportable transactions by the large technology platforms in the FTC's study exceeded $50 million.

That the PCOA is unlikely to capture killer acquisitions—again, to the extent they are taking place—does not mean the bill is without effect. The PCOA shifts the burden of proof to the acquirer for all acquisitions that exceed the $50 million threshold—including those acquisitions that exceed $101 million and are thereby reportable under the HSR Act.[16] This means that some firms, merely because of their size and the market in which they operate, will face a different, more burdensome, legal standard for merger review. While, in theory, the presumptions of illegality in the legislation are rebuttable, in practice the burden of proof is likely to be insurmountable. The PCOA leaves "nascent competitor" undefined and yet requires the covered platforms to provide "clear and convincing evidence" that they are not acquiring a nascent competitor to avoid liability. The legislation effectively bans all acquisitions by covered platforms thereby deterring many pro-competitive transactions. Instead of promoting innovation, the PCOA will destroy an important source of funding for innovation in technology markets.

The PCOA will institute a merger enforcement regime predicated on imposing per se liability based on firm size. This dramatic change to merger enforcement is both unnecessary and unlikely to deter and prevent killer acquisitions. The problem, to the extent there is one, is not with current merger review practices, predicated on evaluating mergers using a rule of reason approach, but with HSR-reporting requirements. Most of the killer acquisitions identified in the pharmaceutical industry were valued below the HSR-reporting thresholds. Current merger review procedures are adequate to identify potential killer acquisitions provided the proposed transactions are reported to the antitrust agencies. Therefore, instead of imposing a sweeping change to merger enforcement based on firm size, Congress should consider more narrowly tailored interventions such as reducing the HSR-reporting thresholds.

CONCLUSION

Congress should not discard long-accepted merger review standards based on the rule of reason in favor of irrebuttable presumptions which amount to a per se liability standard based on firm size as proposed by the PCOA. The burden-shifting imposed by the PCOA would effectively end all merger and acquisition activity by large technology platforms cutting off a vital funding source for innovation. The legislation will be ineffective at achieving its stated purpose while harming start-up innovation. Like the Competition and Antitrust Law Enforcement Reform Act introduced last year, the PCOA is a solution in search of a problem as killer acquisitions in technology markets are likely to be rare.[17] Senators should recognize the importance of acquisition for start-up innovation and take this bill back to the drawing board.

About the Author

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Prior to joining the ITIF, Julie worked for 14 years in the Bureau of Economics at the Federal Trade Commission and served as an advisor to the director of the Bureau of Economics, Chairman Joseph Simons, and Commissioner William Kovacic. Before joining the FTC, Julie was an assistant professor of economics at Trinity University in San Antonio, TX. She received her Ph.D. in economics from Michigan State University.

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