Crushing David on the Way to Fight Goliath: How the Federal Trade Commission's War on Bigness Will Also Hurt Small Businesses

BY JESSICA MELUGIN
ANTITRUST AND COMPETITION FELLOW

INNOVATORS

Innovators Network
1401 K ST NW
Washington D.C

INNOVATORS

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Introduction

The current leadership of the Federal Trade Commission (FTC) has declared war on "bigness" in the U.S. economy, citing concerns about industries concentrated with large firms. "Every nook and cranny of our economy has consolidated," FTC Chair Lina Khan told *The New Yorker* in 2021, the same year she was appointed to head the agency.[i] Accordingly, the FTC has set about raising the regulatory burden of mergers and acquisitions to deter more transactions and attacking current dominant firms with investigations and legal proceedings. This paper examines how these FTC actions aimed at curbing "bigness" will also result in harm to smaller firms.

Specifically, the FTC's new merger guidelines will chill the healthy ecosystem of innovation that relies on smaller firms gaining capital and return on investment from being acquired. Additionally, more stringent Hart-Scott-Rodino (HSR) pre-merger notification rules will contribute to that same problem and may also lead to the next big industry consolidation, "Big VC." Finally, the FTC's case against behemoth online retailer Amazon will hurt the small sellers who depend on the platform for critical customer reach and delivery logistics.

Barriers to Entry = Barriers to Exit

Start-ups looking for funding and hoping to be acquired will be harmed by the more stringent merger guidelines, along with the harm to the big potential buyers the FTC is claiming to deter from further growth. Being acquired is a common and effective way for start-ups to secure funding and to allow investors and founders to recoup their investments. Mergers and acquisitions have become even more critical for smaller companies since the implementation of costly Sarbanes-Oxley compliance was increased, erecting a higher barrier to the alternative of pursuing an IPO. These regulatory burdens fall disproportionally on smaller firms.[ii] The virtuous cycle of acquisition profitability motivates entrepreneurs and venture capitalists to bring new ideas to market, ultimately benefiting American consumers. If being acquired becomes more costly or less reliably allowed by regulators, small businesses may likely have more trouble finding venture capital firms willing to invest. This distortion of decision-making will lead to less opportunity for small businesses to thrive and consumers to benefit from innovations.

Treated as suspect by the new merger guidelines, the practice of selling to a larger firm is common and accepted in the real world. The practice of being acquired is sufficiently "business as usual," that it's featured prominently in the book, *Venture Capital for Dummies*. The product page for the book notes that, "[m]ost exits these days involve larger companies acquiring a start-up company to gain a strategic advantage. Big companies often use acquisitions as their R&D departments, and your payoff comes from solving their big problems."[iii]

A 2022 survey by the National Small Business Association found that, "nearly half of the small-business owners, 43 percent, say a merger or acquisition is important to their business exit strategy."[iv] Andrew Sherman, a partner at legal firm Seyfarth Shaw LLP, told a Small Business & Entrepreneurship Council audience that, "our small businesses across the country, many that are not venture-backed, are relying on a pathway to exit and many of them are relying on exit via merger and acquisition, and in particular Davids selling to Goliaths."[v]

The acquisition path also benefits consumers. In a 2020 paper entitled, "Horizontal Mergers and Innovation in Concentrated Industries" published in *Quantitative Marketing and Economics*, Brett Hollenbeck notes that, "the prospect of being bought out by an incumbent with deep pockets may also encourage entry into the market by new firms, encouraging the development of new products and technologies."[vi] It would seem that the carrot of acquisition drives more competition, not forecloses it.

Empirical data supports the opinion that selling is a common and beneficial mechanism for spurring investment. In a forthcoming article for the *University of Chicago Business Review*, Jonathan Barnett finds that:

> "…during the same period in which platform incumbents have purportedly suppressed competition through predatory acquisitions of small entrants, technology markets have exhibited strong growth in VC investment and startup entry. From 2005-2019, the annual number of investments in US-based startups by venture capital (VC) firms increased from 2,995 to over 11,359 per year and the annual dollar amount of VC investment in US-based startups increased from almost $23 billion per year to $133.4 billion per year. Moreover, as of 2019, approximately two-thirds of US VC investments flowed to relatively smaller emerging companies (at valuations below $100 million)."[vii]

A 2017 National Bureau of Economic Research (NBER) study by Gordon M. Phillips of Dartmouth College and Alexei Zhdanov of the University of Lausanne scrutinized the relationship between venture capital activity and mergers and acquisitions globally, across jurisdictions with varying levels of regulatory permissiveness. They found "evidence of a strong positive association between VC investments and lagged M&A activity, consistent with the hypothesis that an active M&A market provides viable exit opportunities for VC companies and therefore incentivizes them to engage in more deals."[viii] The opportunity to be profitable via acquisition clearly motivates investors to engage.

In a May 2022 study, Tiago S. Prado and Johannes M. Bauer of Michigan State University examine the effects of 32,367 venture capital deals and 392 tech start-up acquisitions by U.S. tech giants Google, Amazon, Apple, Facebook, and Microsoft from 2021 to 2020 for their effect on venture capital funding to emerging firms.[ix] They found "evidence of a positive, statistically significant increase in venture investment in the industry segments in which the acquired start-

ups operate," and that, "there are no detectable, systemic negative effects on start-up funding.[x]

Conversely, making the legality of those potential acquisitions more questionable, as the new merger guidelines do, may chill entrepreneurial efforts, and depress interest from investors, ultimately resulting in less innovative products and services coming to fruition. While the guidelines may deter already large, would-be buyers from growing even larger, as the FTC intends, it's unwise to ignore the other half of that equation: the smaller start-ups that won't be funded or acquired. Those smaller firms have already been deterred from another avenue of raising funds and recouping investment by the increase of regulatory costs associated with initial public offerings (IPOs), but more on that later.

The stricter merger guidelines introduce uncertainty into that path to profitability by making more reported mergers subject to objection, thus introducing a harmful distortion into the decision-making process. The new guidelines introduce more stringent metrics, like smaller changes in the Herfindahl-Hirschman Index (HHI), a common measure of market concentration, as a structural red flag for the FTC in evaluating acquisitions. In his paper, *The Rule of Law and the Draft Merger Guidelines*, Gregory J. Werden gives the example of a market with seven firms with shares of 25, 20, 16, 14, 10, 8, and 7 percent respectively. Under the merger guidelines, the merging of the two smallest firms runs afoul of the new HHI thresholds, even though that would still leave multiple firms and the new firm with only a 15 percent combined market share. He notes, "The Supreme Court never condemned a merger between two of the smallest firms in a market."[xi]

Of course, even if all the possible funding and profitability options were available, a certain number of entrepreneurs will choose to remain independent and look to loans to grow and scale their companies themselves. But those who enjoy starting new ventures, but not scaling them, should be allowed the option to sell. As president of the Center for American

Entrepreneurship, John Dearie, notes, “Many entrepreneurs don’t regard themselves as scalers and growers of companies. They regard themselves as founders, as entrepreneurs, as establishers and that’s what they love to do - found companies and establish them and work to get them on their feet and sell and go out there and do it again.”[xii]

With acquisitions as a beneficial option in a healthy economy, serial entrepreneurs can choose to launch, sell, and invest their payouts in yet another start-up, bringing more new ideas to the marketplace and keeping the pressure on incumbents to innovate. In a May 2023 paper, Aurelien Portuese warns of the FTC taking a hostile stance, “whenever the acquiree appears to be a potential/nascent competitor without providing clear criteria to measure such controversial notions.”[xiii] He explains that the acquisition of a potential competitor does not amount to its elimination and can improve its prospects as a potential entrant in a given market: “Rather, potential competition should refer to the Schumpeterian notion of small firms or foreign rivals disciplining the market before entering it; potential competition should constitute a substantiated and credible defense rather than a speculative theory of harm.”[xiv]

The pharmaceutical industry provides a useful, if morbid, illustration of the harms in over-regulating acquisitions. A niche firm working on a single pharmaceutical might find enough funding to move its product through Phase I of a human clinic trial with 20-80 human volunteers and an average cost of $28 million and Phase II with hundreds of human volunteers and an average cost of $65 million.[xv] But Phase III involves thousands or tens of thousands of people and costs an average of $282 million.[xvi] That last phase may be too heavy a lift for raising capital, and the single-pharmaceutical focus of the firm makes it a poor candidate for an IPO. The path left to bring the product to market is one of being acquired. In this sense, a large pharmaceutical company can outsource its R&D by purchasing a largely “de-risked” product and use its larger scale in funding, marketing, and distribution to get a new medicine or vaccine across the finish line.[xvii] But if the government over-deters acquisitions, patients may not see those cures. In this case, the cost of government regulation might be measured in lives lost.

HSR pre-merger notification rules will further deter acquisitions and may end up concentrating an adjacent industry into “Big VC”

The Hart-Scott-Rodino Act (HSR) is a 1976 federal law that requires businesses to notify the antitrust agencies before a merger or acquisition can occur if the transaction is of a certain monetary value. The proposed increases in the information required to comply with the new HSR rules will raise costs for businesses and are likely to deter a certain number of attempts to acquire smaller firms. This is yet another harmful layer of market distortion, sacrificing the efficiency of capital allocation and innovation.

The changes essentially require all premerger filings to contain what now are only required in a secondary request from the FTC. Previously, that extra information has only been requested in a small percentage of cases. From 2011 to 2020 only 3.1 percent of transactions received a second request. That will greatly increase compliance costs and have the primary effect of delaying and dissuading companies from merging, a consequence that Congress specifically intended to avoid. The proposed rule will include documentation that is not already available to the merging parties, transforming the first reporting requirement into a costly "mini-second request."[xviii]

The FTC estimates the burden on filers would quadruple under the new HSR Filing rules from 37 hours to 144 hours. However, the agency likely underestimates the increased compliance burden. Various law firms that work in these filings think the actual compliance costs will be "multiple times" the FTC's figure.[xix] Former attorney advisor in the FTC's Office of Policy Planning, Daniel J. Gilman, commented, "This seems a 'guestimate' at best, and a lowball one."[xx]

Furthermore, Fred Ashton, competition economics analyst at the American Action Forum notes that, "Delaying mergers and acquisitions, specifically those that are contingent on market conditions, risks lowering the value of the planned transaction or abandoning them altogether."[xxi]

A professor at the University of Pennsylvania Penn Carey Law School put the increased compliance costs this way:

> "Perhaps the best way to capture their scope is to note that FTC's own estimate of annual compliance costs, which would increase from approximately $120 million today to more than $470 million under the proposed changes. That amount exceeds the $465 million combined 2023 antitrust budgets for the FTC and the U.S. Department of Justice's Antitrust Division."[xxii]

Perhaps most alarmingly, Accounting and finance professor Gordon Y. Billard of MIT's Sloan School of Management writes: "Small target firms are likely to be most greatly burdened by the proposed changes." He explains that, "They tend to have fewer available resources to assemble information, yet the same new information requirements as far larger firms."[xxiii]

The practical consequences of increased stringency of merger guidelines and a more arduous HSR process may end up concentrating power elsewhere in unexpected ways. Competition law sometimes inadvertently causes or exacerbates the very problem it's attempting to solve. A good example is the Department of Justice's case filed against IBM in 1969 for monopolizing the general-purpose mainframe computer market in violation of section 2 of the Sherman Act. Thirteen years later, in 1982, the DOJ admitted that the suit was "without merit and should be dismissed."[xxiv] But in the meantime, IBM *raised* its prices to its customers. With the looming threat of suppressed market share and commensurately reduced profitability, if the government's case proved successful, the incentive for IBM became to prioritize maximum profitability immediately; that meant charging higher prices. Antitrust action created the very problem it was aiming to fix.[xxv]

Similarly, the 2002 Sarbanes-Oxley Act (SOX) was passed to improve the auditing of U.S. public companies in the wake of financial scandals, like Enron and WorldCom. But for whatever improvements the law created for investors, SOX also increased the cost and complexity of taking companies public (IPOs). Jeff Farrah, general counsel for the National Venture Capital Association, explained the reason for acquisitions being such a ubiquitous exit today is "that the public markets have become more and more hostile over the years to small and medium-cap companies."[xxvi] Public numbers on trends away from IPOs towards mergers and acquisitions are not publicly available, but it stands to reason that increased regulatory compliance costs, at least in some part, drove smaller tech companies away from an IPO as an exit strategy and towards one of being acquired by larger tech firms instead.[xxvii], It's reasonable that this regulatory shift of incentives contributed to the creation of the very same "Big Tech" firms that the FTC is currently pursuing in various antitrust suits and with the regulatory changes discussed in this paper.

No one can predict all the unintended consequences and distortions of government meddling in markets, but managing partner of Fresco Capital, Stephen Forte, has a worrisome prophecy for the heightened regulatory compliance costs in the draft HSR rules. As a venture capitalist who experienced firsthand how SOX impacted the start-up tech industry, he thinks he sees the next wave of government-driven unintended market concentration. He foresees the coming of "Big VC" as only four or five of the largest VC firms funding start-ups have the scale to offer aid in navigating the increased regulatory compliance the new HSR rules demand. Forte describes this coming regulatory landscape as an "existential threat to [his] small VC."[xxviii]

The lawsuit against Amazon may result in harm to independent small sellers on the platform

In November 2023, the FTC and 18 state attorneys general, and Puerto Rico sued online retailer Amazon, "alleging that the online retail and technology company is a monopolist that uses a set of interlocking anticompetitive and unfair strategies to illegally maintain its monopoly power."[xxix] The government claims that, "Amazon's actions allow it to stop rivals and sellers from lowering prices, degrade quality for shoppers, overcharge sellers, stifle innovation, and prevent rivals from fairly competing against Amazon."[xxx]

The suit appears to be a solution in search of a problem; both consumers and the small and medium-sized businesses (SMBs) that sell on the platform seem pleased with their partnership with Amazon. The company ranks number one for brand value[xxxi] among U.S. companies and number three for trust, with the conductor of that survey reporting that "The brand has established an image of continuous improvement and transparent services."[xxxii] Amazon boasts 167 million U.S. members; that's more than half of the entire U.S. population.[xxxiii], It also has a 99 percent two-year renewal rate for Prime subscriptions.[xxxiv] Those are not statistics indicative of a company abusing its market power by neglecting its customers.

Smaller sellers also seem to be thriving from their relationship with the platform. That's because when smaller third-party sellers on the Amazon platform succeed, Amazon succeeds. Amazon has every incentive for its partner sellers to thrive precisely because Amazon has skin in the game via the fees it charges to them. The more those companies sell, the more revenue Amazon receives. SMBs products account for close to 60 percent of all units sold on the site.[xxxv] As of the fall of 2022, there are nearly 500,000 SMBs selling on Amazon.[xxxvi] American third-party businesses averaged a rate of selling 7,800 products per minute on the platform for a total of 4.1 billion items sold in 2022.[xxxvii] The company reports investing "more than $30 billion in logistics, tools, services, programs, and people to foster the growth of [their] sellers."[xxxviii]

The incentives align between Amazon and its SMBs. The growth of these smaller businesses, aided in their success by Amazon, also drives second-order benefits by creating more jobs and prosperity as those small businesses grow faster than they otherwise would have without the reach, scope, and services of Amazon.

Whatever the FTC's quibbles are with the specific terms of the contracts with sellers, it's undeniable that small and medium third-party sellers are able to leverage Amazon's scale to their own benefit. The scope of potential customers they have access to would be impossible without Amazon. The logistics services Amazon provides (optionally) free sellers to spend their time making more products or innovating, instead of standing in line at the post office. The fees SMBs pay to Amazon are akin to paying for the benefits of Amazon's huge scale in terms of the sheer number of customers providing value to small sellers. This is a revolution as compared to the days of Walmart and other big box stores competing against small businesses on Main Street at the turn of the last century. Amazon benefits from a seemingly endless variety of inventory, and SMBs gain the scope and scale of one the world's largest companies. In his paper, "Apocalypse Not: The Resilience of Retail SMBs in the 2010s," Robert

Kulick finds that SMBs, "experienced a period of resurgence and growth in the 2010s."[xxxix] He concludes from the empirical evidence presented in the paper that there is a direct link between that growth and SMBs', "increased adoption and use of digital and e-commerce technology."[xl] Certainly Amazon's third-party marketplace for sellers has played a large role in that trend.

But if the FTC is successful in its suit against Amazon, possible remedies include breaking apart the businesses of first-party sales, third-party sales, and logistics services currently offered. That would harm small sellers. They lose the immediate benefit of Amazon's scale, in terms of small businesses' products being exposed to many more potential customers simply by being featured on the website. SMBs might also lose the logistics services that Amazon offers. The "unbundling" of logistics services from the platform's marketplace might better be understood as breaking the entire system. According to Amazon's 2022 numbers, "shipping with Fulfillment by Amazon (FBA) costs 70 percent less per unit on average than premium options offered by major U.S. carriers comparable to FBA, and costs 30 percent less per unit on average than their standard shipping options."[xli]

In the extreme, Amazon might decide that hosting a marketplace for third-party sellers isn't worth the legal trouble and close the third-party marketplace altogether. Cutting off small sellers from this extremely valuable channel would be the antithesis of what the FTC is claiming to do in protecting "the little guy."A September 2023 Small Business Check Up Survey Q3 published by SBE Council revealed that small business owners who utilize the Amazon platform are alarmed about FTC action against Amazon's third-party marketplace.[xlii] The SBE found that, "Nearly 80% of small businesses that sell on Amazon expect negative consequences from potential FTC interference, including sales disruption, employee layoffs, loss of their customer base, potential business closure, and increased sales and marketing costs."[xliii] If the FTC is claiming it's protecting these small sellers, their own level of concern about FTC action tells a very different story. In light of these survey results, it's difficult to view the suit as benefiting small sellers and much easier to interpret it as punishing Amazon for its success.

Conclusion

The FTC's efforts to make acquisitions more difficult and expensive, coupled with the agency's litigation against Amazon, comprise an unintended regulatory war on many of America's small businesses and their founders. Whatever the good intentions or merit of addressing market concentration and the growing size of the country's largest firms, there's little justification for the toll it will take on SMBs and start-ups. Government meddling in the economy rarely comes without harmful, unintended consequences. Unfortunately, it seems SMBs will be this round of regulatory enthusiasm's latest victims.

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