*Insight*

# REGULATION, POLITICS AND BIG TECH

Much of the social, economic and political development of the modern period is driven by technology, innovation and disruption. Steam power, combustion, electricity, telephony, computing; and today, digital transformation has become the defining driver of our age. The big digital and technology companies have become truly gargantuan and count their market capitalization in trillions. In previous insights we have written about the prospects for the internet sector (July 2015) and how the shift from offline to online is not a fad but fundamental. We have also written about the impact of these new business models on the structure of the economy (March 2016). With the upcoming US elections and with even Kim Kardashian taking a break from social media, it is time to reflect on the impact of regulation and politics.

The Covid-19 pandemic has accelerated the change and disruption we have seen over the past ten years. Work, consumption, education and social life has shifted online. The discussion around the technology sector and its biggest companies has accelerated too. Before the question was if the companies could grow further and if they had reached their peak. Now there are two questions:

The first goes back to the origins of capitalism, to Standard Oil and the trusts of the 19th century. The big digital and technology companies have provided unprecedented opportunity and utility for their users and customers. They have played a critical part in enabling the global economy to continue to function despite the physical distancing and other measures that have had to be imposed to control the Covid-19 pandemic and to avoid the economic collapse that would have been inevitable. After all Standard Oil made kerosene widely available and lowered its price to a point where it could make money, but others could not. But despite all that, have they become monopolies and are they abusing their power?

The other question is completely new. The big digital companies have completely changed how we search for information, get news and interact with family, friends and society at large, allowing us to have a constant connection and community with virtually unlimited creativity and freedom of content and expression. However, they have also created immediate channels for political and social information and disinformation, which throughout the 20th centuries have been limited by the existing channels and regulated by governments and legislation. The political polarization we have experienced has raised the question of whether the social media platforms have a responsibility for the content they offer to their users. The question is complicated greatly by their global reach. Of Facebook's 2.7 billion monthly active users less than 700 million are in the US and in Europe, a tremendous opportunity but also an issue because the majority of users are in countries that in many cases have very different definitions and approaches to the rights and freedoms they afford their populations.

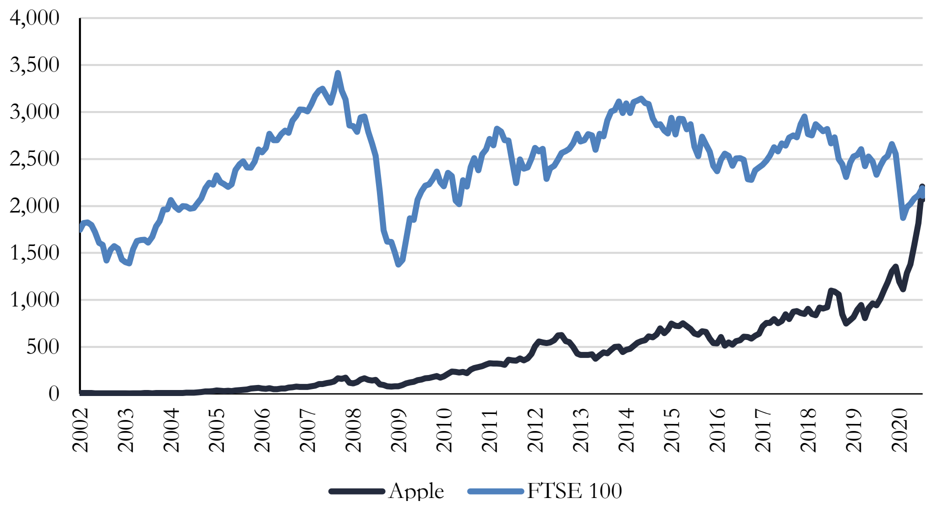
So, are the big digital and technology companies' part of the problem or the solution? Have they become too large and have they become detrimental to society?

First there is their staggering scale. Apple was the first technology company to pass $1 trillion in market capitalization in 2018 and was followed by Amazon, Microsoft and Alphabet in the following two years. Apple has subsequently reached over $2 trillion and at one point this year was worth more than the entire FTSE100 in the UK.

J. Stern & Co
4 Carlton Gardens
London SW1Y 5AA
United Kingdom

Tel: +44 20 3478 1800
Fax: +44 20 3478 1799
info@jsternco.com
www.jsternco.com

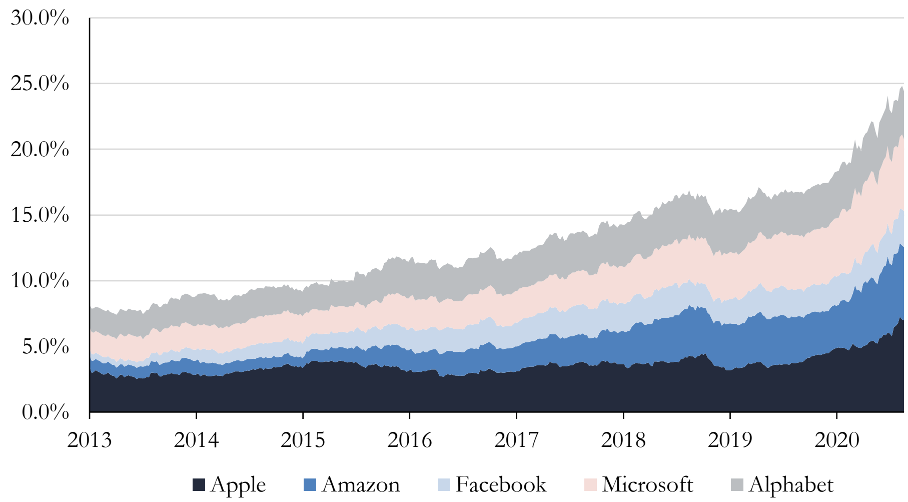
**Market Capitalisation in $bn**




Source: Bloomberg

Including Facebook, the big five technology companies represent almost 25% of the S&P 500 and a combined market capitalization of almost $7 trillion. This concentration effect has drawn considerable scrutiny over their importance to the economy and to everyday life.

**Big 5 Technology's share of S+P 500**




Source: Bloomberg

At the end of July, four of the big five had their CEOs testify in Congress as part of an investigation into online platforms and market power. The testimony took place on Zoom but the images of Tim Cook, Jeff Bezos, Sundar Pichai and Mark Zuckerberg echoed those of the CEOs of the oil, tobacco or financial companies hauled in front of Congress at earlier times of crisis and misconduct.

Satya Nadella did not testify but Microsoft has been under antitrust scrutiny for decades over the market position of its Windows operating system, its availability of access to developers and the bundling of its own services and software. Most recently it has come under investigation in the European Union where Slack has brought a case regarding bundling. It is on similar lines of argument to the 2004 case involving Windows, where it was deemed that Windows illegally bundled Windows Media Player with its operating system, reducing competition in the media player market. Slack is alleging that Microsoft's new Teams product, which is offered in a bundle with other Microsoft products, is reducing competition in the collaboration software market. History does not rhyme but it does repeat for the big tech companies.

It is not surprising that media and public sentiment has turned decidedly negative towards the big tech companies. From previously being held up as champions of innovation and inspiring stories about being built by geeks and dropouts in garages and university dorm rooms, they are now characterized as a menace to society.

Old media such as newspapers and TV have suffered as advertising has shifted online. With its better attribution and wider reach, Facebook and Google capture the lion's share of this online advertising market. As supportive as we are of a free press and as concerned we are about the ability of old media to adapt its business models, as Facebook and Google succeed, it is obvious that the press has a vested interest in negative coverage towards their competitors. Additionally, the big tech companies have founders still in control, notably Jeff Bezos at Amazon and Mark Zuckerberg at Facebook, making the companies more human and thrusting them into the spotlight. As these two CEOs still own significant stakes in the companies they founded, the daily fluctuations of their net worth generate easy media headlines. This contrasts with many other large companies in other industries whose CEOs and founders are not as visible to the public. Bernard Arnault has built LVMH into the largest luxury goods company in the world in part by buying up one competitor after the other who could not compete with LVMH's scale and resources, yet we read far fewer stories about him despite being the second richest man in the world.

Politics and media play a key role. In the US and elsewhere, the big tech companies have become a political punch bag receiving ire from all sides of the political spectrum.

Democrats had been positive towards the technology sector for much of the 2000s. However, in the last couple of years this sentiment has changed and gathered pace, in part thanks to Elizabeth Warren's impassioned manifesto to break up big tech in March 2019. We have also seen Rohit Chopra, a Democrat on the FTC, noting last year that there should be specific competition regulations for digital platforms. In general, they take a more critical view of free trade and market-based competition. Republicans are concerned about neutrality and political bias on the platforms because they view the big tech companies and their CEOs as pro-liberal. Especially in the lead up to the US presidential election in November, Republicans have been seeking what they perceive as a more neutral political stance from big tech.

Despite the government and regulatory scrutiny and negative press, the share prices of all big five tech companies continue to rise during the Covid-19 pandemic and have reached all-time highs. Will the new US administration and Congress act? Will people change their habits? Should Wall Street care?

It certainly appears to us that we should care after watching the CEOs of Amazon, Apple, Facebook and Alphabet all testifying in front of Congress. The testimony was instructive. All four of the companies are being investigated on antitrust grounds. The Department of Justice is reportedly working on the cases on Alphabet and Apple, while the Federal Trade

Commission oversees the investigations into Amazon and Facebook. The testimonies were an information-gathering exercise for senators as they grappled with the different cases against each company. We felt that the senators were much more prepared than during the investigation into the Cambridge Analytica data leak two years ago, when Mark Zuckerberg testified in the Senate and was asked by an obviously baffled senator how Facebook can make money when its services are free to its users. Zuckerberg's short answer "we sell ads" was historic and went viral. This time the questions were more probing, and each party had a coordinated approach. The CEOs were regularly interrupted, and we felt were very much on the backfoot during the questioning.

Source: www.fastcompany.com

We expect that these investigations are going to be in-depth but specific, because of resource limitations and other constraints within each agency. It is possible that they will decide to prioritise one investigation over the other. Our view is that the DOJ will focus on Alphabet and that the FTC will focus on Facebook. The FTC are most likely still in an information-gathering stage regarding Amazon since the current pandemic has brought about a perfect experiment of what a world of only online shopping looks like to examine Amazon's market power. It is important not to forget that there are also the state attorney generals who can bring a case against the companies, and in particular Amazon, through a prism of consumer protection. This provides a mechanism of additional oversight to the Federal agencies and may lead them to focus on Alphabet and Facebook with their advertising revenue models rather than Amazon with its revenues from individual consumers and third-party sellers.

However, the timing of the US election could be critical in terms of the progress of each of these cases. The DOJ, FTC and FCC heads are all presidentially appointed. As such, whoever wins the White House will also effectively control the technology regulation path. If the Democrats win, the new President Biden will certainly decide to appoint new heads of the DOJ and the FTC. Depending on the outcome of the congressional elections, there could be a time delay of six to 12 months for these appointments to be made. Additionally, the new heads of department could decide to take the investigation in a different direction or extend the scope.

The current administration could decide to accelerate a case. We think it is possible if not probable that the DOJ will bring a case against Google before the end of the year. It could even be prior to the election in order to gain maximum publicity. Indeed, it has been reported that Attorney General William Barr wants to file the antitrust case against Google by the end of September, despite government lawyers working on the investigation requesting more time. The case against Google will most likely cover the advertising business and the ad tech software that Google has created, including examining the acquisitions of DoubleClick and AdMob. However, the case could be extended to cover other areas such as search bias, which could also involve political bias and therefore could provide political headlines in time for the elections. We think that the state attorney generals are also interested in the search bias investigation and that they could bring their own case if the DOJ does not extend it far enough.

We think that these investigations portend three different areas of policy risk for the big tech companies. The first is antitrust. This covers the market power of these companies, restricting competition and with a focus on past M&A. The second is on privacy and bias. This covers issues on data ownership, privacy and protection as well as bias towards their own products and services. The third is Section 230 of the Communications Decency Act, which is the clause that allows the big tech companies such as Google, Facebook and Twitter to manage content freely without liability. President Trump has issued an Executive Order regarding Section 230 earlier this year in response to social media platforms acting to remove posts deemed to violate their community standards, which has raised the stakes and thrown the debate regarding online censorship and the possible outcomes into sharp relief.

The first policy risk is the issue of whether past acquisitions should be unwound. During the testimonies, Facebook came under intense questioning for its purchase of Instagram. Under Facebook's ownership, Instagram has grown significantly with over 1 billion monthly active users. This is significantly more than the approximate 40 million users it had at the time of acquisition. One argument is that Facebook provided the resources for Instagram to grow to this scale. Critics of the acquisition argue that Instagram would have been a meaningful competitor and that the company would have been successful or even more successful without Facebook's involvement. They say it would have provided a better experience for users and an alternative for advertisers. Facebook will fight hard to prevent a divestiture of Instagram as the platforms are deeply integrated with shared code and back end software development. However, if it is shown that they have done this integration in order to make it more complicated for the FTC to force a divestiture it would be viewed most negatively by the courts.

The big tech companies are finding it increasingly difficult to make acquisitions, even in adjacent areas due to these competition concerns. For example, Google is currently in lengthy investigations to approve its Looker and FitBit acquisitions, which are both outside of its core search business. Technology by its nature constantly evolves and one way of keeping up with trends is to acquire rather than build it yourself. Yet it is also becoming problematic to build your own version raising issues for fear of copying, as evidenced by Microsoft and Slack, the EU investigations and into how the product is sold and marketed. As such, the big tech companies will have to walk an increasingly fine tightrope and we view moves into completely dissimilar early-stage markets, such as the investment in Waymo and self-driving cars by Google, as ways of pre-empting or avoiding this problem.

The DOJ and FTC have not disclosed the focus of their investigations, but we think that all four of the big tech companies are under initial investigation regarding this antitrust risk on market power. In no particular order, Apple is exposed to issues of market power due to its ecosystem of operating system, AppStore and payment mechanism. The most immediate question is its AppStore and whether its 30% commission is too high. Epic Games, the parent company behind the hit game Fortnite, has filed a complaint against Apple's commission rate and has launched a concerted PR attack. Amazon has significant market power in online commerce and faces the question of whether it is forcing unfair practices on third party sellers. Facebook is suspected of using its acquisition of Instagram to prevent viable competition in social media advertising. Google has a 90% share of search and is facing investigation into its advertising technology stack and the possibility that its acquisitions of DoubleClick and AdMob have prevented meaningful ad tech competition.

The second policy risk is on privacy and algorithm bias. Facebook has already been fined $5 billion by the FTC after the Cambridge Analytica scandal for mishandling users' data and ineffective data privacy controls. The big tech platforms collect significant amounts of data which can be used to provide better and more tailored services, as well as improving AI research and development. Data has become very valuable with a battle over who can control it.

President Trump has used the grounds of data and the national security threat of the theft of data, intellectual property and technology as justification for sanctions against Chinese technology companies. These include ZTE, Hikvision, China Telecom and most notably Huawei, the telecom equipment manufacturer, with US firms now prevented from using Huawei technology or providing technology to Huawei. Most recently, President Trump has demanded that the US business of TikTok, a popular social media app with young people but with a Chinese parent owner, be incorporated as a separate US corporation and have a significant US corporate investor if it wishes to avoid being banned from operating in US. They key justification for this unprecedented step was concern about the 100 million US users' data and the real or perceived greater control through a US incorporated business. At the time of writing, it has been reported that Oracle, whose founder Larry Ellison is one of a few prominent Republicans in Silicon Valley and has been reported as having hosted a fundraiser for President Trump at his home earlier this year, has won the bid to partner with TikTok. Along the lines of the argument about Google and autonomous driving, TikTok is an emerging player in social media advertising that has little in common with Oracle's core business of selling databases and enterprise software. As such, the limited overlap should help to ease competition concerns that could be raised if for example Facebook or Microsoft had attempted to acquire it.

The TikTok issue highlights the international dimension of the political and regulatory issues for big tech. The EU has always taken a more aggressive stance towards data protection and regulation both through legislation like GDPR and through investigations and fines. However, these actions have been part of the broader political, economic and social alignment between the US and the EU and despite at times substantial disagreements are based on shared principles and concerns. Globally however, there is a growing possibility of a 'tech cold war' brewing between USA and China over data and privacy regardless of who wins the presidential election. China faces important issues of protection of intellectual property and market access for the US and the EU but the way in which they are addressed matters. President Trump has chosen a more personalized and adversarial approach than previous administrations and appears likely to continue on this path if he wins a second term in office. Joe Biden may want to be seen to be taking a hard line on China for any number of reasons that have affected US/China relations over time, including US union concerns around trade and tariffs and the need to maintain political posture in what is likely to be a polarized political environment.

Chinese companies already have some support from their own government as Google and Facebook are excluded from operating in China due to the firewall. The Chinese government could also retaliate against the sanctions and put further restrictions on American companies, such as banning Apple from selling products in China. Whilst this is unlikely, we do not rule out a further decoupling between the two countries. It would also have a further effect of forcing other countries to take sides between China and the US.

The Chinese internet giants, Alibaba and Tencent, are global digital leaders and are more technologically advanced in some areas than the big US tech companies. For example, the growth and usage of mobile payments through super apps is much more advanced in China. The upcoming Ant IPO is set to be one of the largest ever, valuing the company at over $200 billion. In this political context, given the importance of digital transformation for global growth and development, the ability of the big US tech companies to operate as successfully as they have in many markets is likely to be a strategic objective for the US. The ongoing resistance of the US to harmonize global taxation of e-commerce and the current administration's willingness to enter into a trade war with France over a digital tax is evidence of this objective. It is therefore possible that an explicit or implicit argument could be made during any antitrust hearings that they need support from their own government in order to compete globally against the Chinese giants rather than being broken up and fined.

We think that the scope of the investigations regarding the second policy risk of data privacy and bias could be extended to include Google and Facebook. Facebook has already been fined and reached a settlement with the FTC regarding data breaches and the Cambridge Analytica scandal, so we do not think that there is necessarily more to come. Data privacy is an important issue for both Google and Facebook with their business models relying upon using data to best serve adverts to users. The EU has introduced GDPR covering this data protection and privacy. It has resulted in tracking cookies consent appearing on webpages but has not resulted in a meaningful negative impact on the business models of Facebook or Google, despite individuals being given more control over their data.

However, as regards algorithm bias Google is likely to be investigated given it has been shown in previous investigations to have search bias in favour of their own products and services. Google has already been fined by the EC on this matter and had to amend its shopping feature. This bias would also cover political motives and Google and Facebook may need to adjust in order to be viewed as more politically neutral especially in the lead up to the US elections.

The third area of policy risk is around Section 230 and online censorship. The social media platforms are at a critical juncture in how they handle content on their platforms and Mark Zuckerberg and others at Facebook have been vocal about the implications of running a global platform with different legal, regulatory and social requirements and expectations. The shield of Section 230 is likely to be amended given the Executive Order from President Trump. If he wins a second term, he could then require Facebook and Google to take a more proactive stance towards censorship and moderation. However, we feel that it is a delicate balancing act between protecting free speech and censorship. Facebook has invested heavily into hiring more moderators and AI technology to try to prevent fake news and inflammatory content being spread on the platform. It also publishes a transparency report each quarter tracking its progress. However, we do not know what the best solution will be to balance free speech and censorship and in particular it is entirely unclear if applying community standards and exercising ever greater influence over content driven by concerns about liability would benefit President Trump's likely desire to continue posting on social media in the way that he has. We think that the pendulum will swing back and forth between the two principles and it will take time to find the best solution for all parties.

Regarding the investigations, we feel that Facebook and Google are exposed to all three areas of policy risk, and so it is most likely that cases will be filed against them. However, the scope, degree and timing of these cases will depend on the outcome of the election. This would also influence the enforcement of any penalties.

Traditional antitrust focuses on the consumer harm which can be most simply summarised in the form of raised prices. However, given that these big tech platforms are free to the consumer, or in Amazon's case offers lower prices, then it is more difficult to identify harm. The EU has taken a viewpoint of a public interest standard regarding competition policy. It looks at whether a lack of choice is a harm. It has also been more proactive in terms of regulation by introducing GDPR and fining Google over €8 billion in aggregate. However, neither of these actions has materially affected the business and Google has over $120 billion in cash on its balance sheet.

In conclusion, we think that the landscape is still uncertain regarding the effect of antitrust for the big tech companies. It does seem likely that cases will be filed, and settlements reached. However, we do not believe that a breakup of the companies is a solution to the issues. We think it is unlikely to be in the US strategic interest and we are certain that it will be resisted greatly. Significant harm would need to be shown and while the platforms remain free we think it is unclear whether the EU's definition of lack of choice as harm will be sufficient in the US political and legal context. We are of course not legal experts, but investors and this question is part of our framework for analysing the long-term prospects for the companies. We think that whilst the big tech companies will have their wings clipped in terms what of the M&A they can do and what new products and services they can launch, they still have great prospects for future growth.

We have seen this year with the Covid-19 pandemic just how necessary big tech is. If there was no online shopping (Amazon), no cloud computing for companies to remote work (Amazon, Alphabet, Microsoft) or people were unable to communicate with family and friends (Facebook, Apple), then the pandemic could have had even more detrimental consequences. Each of the companies are working on applications and services that improve people's lives. Apple and Google are developing track and trace applications using their mobile phone operating systems that have been chosen by governments around the world as a vital resource to fight the virus

The big digital and tech companies may be part of the problem, but they also are part of the solution. Technology and digital transformation will continue to be a primary driver of global growth and is crucial to achieving the development outcomes enshrined in the UN Sustainable Development Goals. That is why it is important that the companies and governments in the US, the EU, China and elsewhere continue to work together and reach the appropriate regulatory resolutions to achieve those goals.

*Giles Tulloch*
*August 2020*