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BIG TECH AND REGULATION – THERE IS NO TERROR IN THE BANG

"This antitrust thing will blow over."

Bill Gates (Speech to Intel executives, 1995)

Last September, we outlined our views about the regulatory threats facing the big tech companies in our investment insight *Regulation, Politics and Big Tech*. Since then, the situation has evolved. Multiple lawsuits have been filed yet share prices have increased.

Given the political, social and economic importance of the major platforms due to their enormous scale in search, social media, e-commerce, cloud computing and other areas of the digital economy, we have updated our analysis and perspectives. The issues include potential abuse of market position, anti-competitive behaviour, violation of data protection and privacy, impact on public discourse and freedom of speech, protection of minors and other vulnerable populations, and politically and socially unacceptable tax avoidance and arbitrage. These are all serious issues for the companies that we have to confront as investors as well.

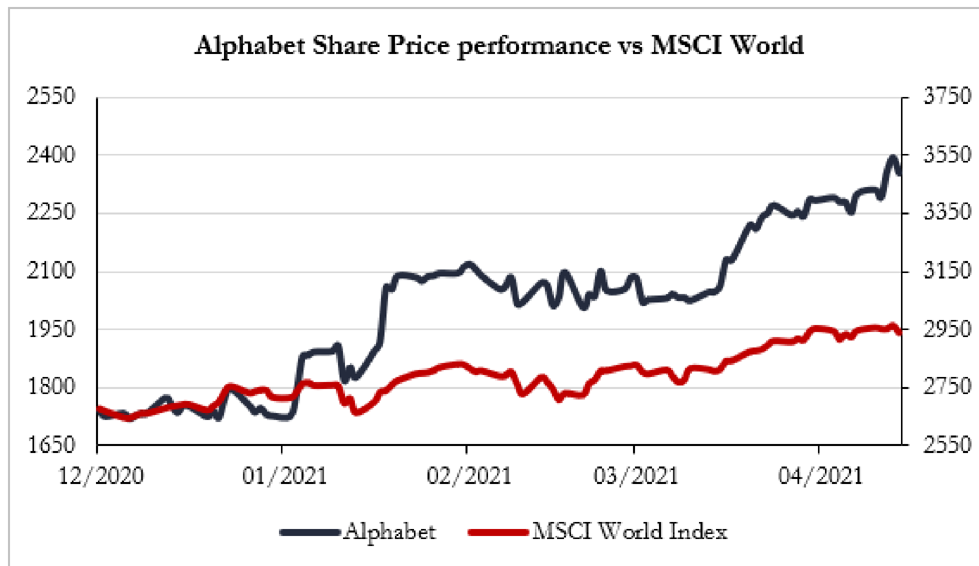
The technology sector is fast moving with many new technologies and companies appearing. Recent progress has been rapid in areas such as quantum computing, blockchain and crypto, as well as distributed cloud and adaptive machine learning technology. Such rapid progress is a challenge for regulators who are finding it extraordinarily difficult to keep up. The laws that are enacted, such as Section 230, then become out of date and are not fit for the current environment. We think this challenge is only set to increase and that a better solution would be to put the burden on the big tech companies by making them self-regulate. There should be greater incentives for big tech companies to work together as a community to create new standards, for example on Section 230, and to be proactive rather than reactive.

Building on our insight last year, we would like to offer our perspective on some of the most important issues.

Alphabet: The reality of lawsuits, costs and settlements

Alfred Hitchcock said "There is no terror in the bang, only in the anticipation of it". Markets fear uncertainty. *Alphabet* took the brunt: by the end of last year, the company had been served with no less than three claims. The first was filed by the Department of Justice (DOJ) in October, while the other two were filed by different groups of State Attorney Generals (AG) in December. Yet Alphabet's share price has increased by some 40% from the last of those lawsuits to the end of April, adding over USD 400 billion to its equity market cap.

Concerns about 'regulation' held investors in thrall and the threat of lawsuits and regulatory action has been an overhang on the company and its share price. However, once the lawsuits were filed the suspense was lifted, markets gained perspective and investors realized that the outcome was not likely to be as bad as feared.



Source: Bloomberg

Our main observation is consistent with what we wrote last year: that these cases are all going to take a long time to reach a conclusion. Three separate lawsuits will require significant resources on both sides especially given the massive amounts of evidence that need to be gathered. Fortunately, Alphabet has no shortage of resources, with more than USD 130 billion of cash available. On the other hand, the State AGs' own resources are limited and must be balanced with other needs. Indeed, the Texas State AG which led one of the lawsuits has recently asked for USD 43 million in additional funding for outside counsel to help work on the case against Alphabet. Their motivation will be for a shorter process and a swift conclusion. This could involve a cash settlement, which would also suit Alphabet given their financial strength. However, if the purpose of any of the lawsuits is to force Alphabet to change its business practices, then an extended and drawn-out case is more likely.

The big tech companies are always innovating and evolving their businesses. If they grow stale, then they risk being disrupted. But at their core they have large, profitable, cash generative businesses that help fund these newer initiatives. The risk for investors would be if those businesses were affected by court cases which require them to divest or change practices.

Facebook: Break-up, divestment, innovation and competition

Echoing the charges brought against Microsoft in the 1990s, the lawsuit filed by the FTC in December alleges that *Facebook* has an illegal monopoly on social networking. The FTC argues that it leaves consumers with few choices for personal social networking and deprives advertisers of the benefits of competition.

The FTC calls for the business to divest Instagram and WhatsApp, unwinding the two acquisitions made in 2012 and 2014, respectively. Facebook is accused of having an illegal monopoly in social networking and of carrying out anticompetitive conduct by purchasing both platforms. Yet when Facebook made these acquisitions, it was scrutinized by the FTC and relevant authorities around the world, all of whom concluded that the acquisitions could proceed.

After almost a decade, and following large investments by Facebook, Instagram has grown significantly, and it is now one of the premier digital advertising platforms. It is difficult to say whether Instagram would have reached its current size without having had Facebook's investment and insights.

This is the problem faced by regulators: facts matter. At the time of the Instagram acquisition, it was unanimously approved 5-0 by the FTC. In the decision by the UK Office of Fair Trading, it noted that Instagram did not generate any revenue, and said that a third party "did not consider that Instagram provides significant marketing opportunities". It added "the commercial opportunities are limited…". Other third parties gave evidence, and while they stated that social apps can develop monetization opportunities once reaching a certain scale, few believed that Instagram had immediate monetization opportunities. Another thought that Instagram would not present a direct monetization opportunity but would just increase usage of Facebook.

We estimate that Instagram generates over USD 20 billion in revenue a year for Facebook. It is now an issue, with regulators who relied on the third-party evidence in their earlier judgements. Facebook recognised the opportunity that existed in Instagram whereas these third parties were unable to forecast its potential success, hence the acquisition. Its ability to forecast trends before they happen is what makes Facebook the leader in the industry. But not all its acquisitions have been or will be as wildly successful as Instagram. Does that mean that only the successful ones should be unwound retroactively ten years later?

The FTC's lawsuit has another issue that is reminiscent of the 1990s as well: We believe that it is backward looking and that there has never been so much choice for users. With the enforced shelter at home measures due to the Covid-19 pandemic, people have been forced to communicate and socialise virtually rather than face-to-face. As such, there has been a rapid rise in group video conferencing, with Houseparty (owned by Epic Games/Tencent) and Zoom emerging as two of the most popular. For enterprises and work settings, Microsoft Teams, Zoom and WebEx (owned by Cisco) have proven to be the most effective.

Source: Zoom

This has been just the beginning, as other video apps have risen in popularity. Twitch (owned by *Amazon*) has soared in viewership, whilst Discord has risen from 56 million monthly users in December 2019 to over 140 million monthly users. Microsoft expressed an interest in acquiring Discord earlier this year, which the platform rejected. Discord recently announced a partnership with Sony, which will see Discord integrated into the PlayStation experience. These platforms have evolved from just video gamers streaming their games to broader communities who use them to socialise. This chart shows the global growth of Twitch viewers as it continues to swell to new heights.

Source: https://twitchtracker.com/statistics

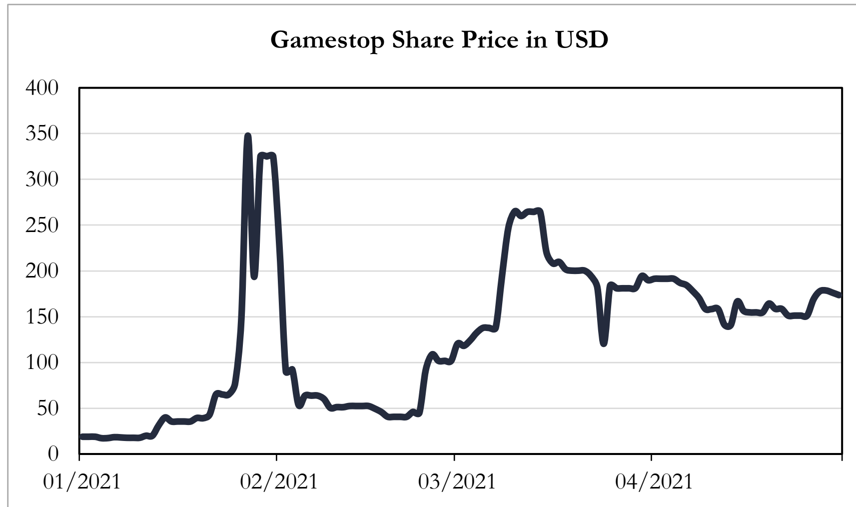
As well as video streaming and conferencing, short video apps have grown substantially in popularity as people found it a creative way to stay entertained. Chief of these was TikTok (owned by Bytedance). TikTok was subject to an order by President Trump in 2020 to sell part of its business on national security concerns, with Microsoft, and then *Oracle* and *Walmart* jointly, all interested in acquiring part of it. The Chinese parent company Bytedance has developed a highly innovative AI powered tool that delivers a constant stream of entertaining videos to users. Other short video apps include Kuaishou (part owned by Tencent, which recently IPO'd) and Triller.

Source: Tiktok

The video game companies have also experienced very high levels of engagement and growth in users, with *Activision Blizzard* reporting a trebling of players on its Call of Duty franchise over the last year. The metaverse is a focus for some publishers, as it creates a virtually shared space where people hang out and socialise, as well as playing video games. It blends virtual and augmented reality with real life. One of the best examples of this was rapper Travis Scott's 'Astronomical' concert held in the computer game Fortnite. Watched by over 12 million people, he reportedly earned USD 20 million for the 9-minute extravaganza. The early internet was full of message boards and forums that have also become popular during the pandemic. Reddit, known for memes and gossip, rose to wider prominence with its WallStreetBets forum, where people gathered to swap trading tips. It even created a new range of trading jargon, such as "diamond hands", "tendies" and "stonks". At the start of the year the forum rapidly grew in popularity with millions of new members joining to buy shares in heavily shorted companies such as GameStop and AMC Entertainment. This caused a large dislocation in the stock market as these stocks were short

Source: Fortnite via Twitter

squeezed and rose sharply. The ease at which retail investors can buy shares through platforms such as Robinhood exacerbated the situation, and swiftly resulted in hearings in the US Congress.



Source: Bloomberg

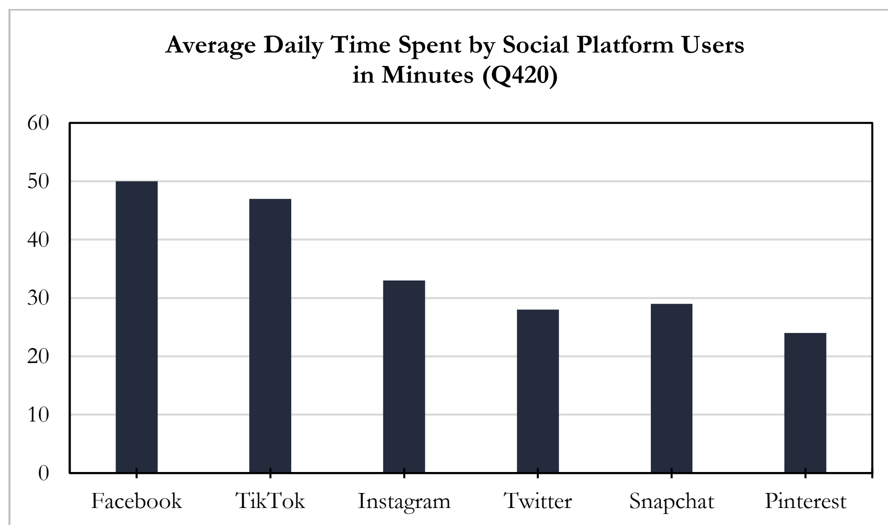
Clubhouse is another platform that has gained in popularity this year, as its invite-only membership congregates and listens to talks held by industry leaders. It has also brought scrutiny from the mainstream media, with the New York Times describing the platform as hosting "unfettered conversations". We feel that there are different standards applied by the mainstream media to these social networks. It felt as if the Reddit situation had a 'David vs. Goliath' narrative in the press, with Main Street taking on Wall Street. There was less conversation over whether the short squeeze could have been a content moderation issue and how social media influences real world events.

None of the platforms we have discussed above are owned by Facebook, and we believe that their diversity, user base and impact provide ample evidence, that it is not operating an illegal monopoly and depriving consumers of choice.

But competition does not just come from innovators and disruptors. Existing established networks have also continued to grow and provide alternative outlets for advertisers. LinkedIn (owned by Microsoft after all) has over 750 million members and grew its revenue by 25% y/y last quarter. Twitter grew users by 20% and revenues 28% y/y last quarter too. Even faster growth came from Pinterest, with user growth of 30% and revenue growth of 78% y/y, whilst Snap saw user growth of 22% and revenue growth of 66% y/y. Pinterest was subject to an approach by Microsoft to acquire it last summer. This approach was one of many made by Microsoft over the past 12 months, as it looks to extend its presence in social networking and complement its LinkedIn acquisition.

To be clear, Facebook has not lost share either. In fact, it has increased users on its core Facebook platform by 250 million over the last year, and on its overall platform by 450 million to 3.45 billion over the last year, of which 'only' about 1 billion are in the US and in Europe. It also grew revenue by 48% y/y last quarter and exceeded consensus revenue forecasts for this quarter by over USD 2.5 billion, which is greater than Snap or Pinterest's entire revenues for 2020.

What we are seeing is that the entire social networking industry has risen in popularity, but Facebook is simply much better at monetizing its audience with relevant and appropriate advertising. According to a recent survey by Cowen, the time spent on the platform is not substantially more than other social sites, which we believe is another important fact highlighting that Facebook does not operate as a monopoly. Facebook is simply better at making money and has a greater ability to expand its service. For example, it has made significant strides into e-commerce, with over 1 million shops and 250 million users on its platform, which is something to keep in mind when the next lawsuits are filed against Amazon.



Source: Cowen & Company; Cowen Proprietary Consumer Tracking Survey, n=~2500, November 2020

Section 230: Politics, constituencies and compromise

We also wrote last year that the result of the US presidential election could shift the way that the big tech companies are regulated. With President Joe Biden and the Democrats having won the election and controlling Congress by Vice President Kamala Harris's single vote, we think that there will be a shift in approach, but not an immediate one.

So far, President Biden has nominated Lina Khan to the FTC. Khan is an academic who holds a critical view of the big tech companies when it comes to competition. He has also hired Tim Wu, another academic critical of big tech, as his advisor at the National Economic Council. However, with Rohit Chopra leaving the FTC to head up the Consumer Finance Protection Bureau, it leaves Biden with one further nomination to the FTC. We believe that there is potentially a lack of candidates who have the relevant antitrust and tech expertise, and who have also not already worked on behalf of the big tech companies, compromising their impartiality. With a one-vote majority in the Senate and other pressing priorities, we think it is likely that the aggressive tech regulation advocated by some in the Democratic party could take a back seat for now.

Section 230 is likely to be the first area regulated, given there is appetite from both sides in Congress. Even Facebook is asking for reform. The company recently suspended President Trump's account after the Capitol Hill riots. This decision was then referred to Facebook's

Oversight Board, itself formed at the request of the FTC, to decide on whether the suspension should be upheld. The Oversight Board is an independent body responsible for promoting free expression whilst making binding decisions regarding users and content on Facebook and issuing recommendations on Facebook's content policy.

Facebook has an issue in that it is a global platform that cannot apply standards across its user base. It has to comply with individual country rules and regulations while maintaining a consistency of approach, governance and accountability. It does not want to censor, but it is increasingly being put into a position where it must do so. Some Republican critics argue that Facebook is too zealous in removing content, resulting in unfair bias. Liberal critics argue that it ignores disinformation and defamatory content which causes damage to society. Facebook is trying to combat misinformation, most recently with Covid-19 and vaccines, as well as the 2020 US presidential election, by introducing fact checking and proactively connecting people with authoritative information.

However, Facebook's concern is that it is not able to capture all the misinformation. The platform would like to change the standard to a duty of care that would apply to all internet platforms to ensure that adequate systems are in place to remove it, rather than being held liable if a particular post is missed. Whilst Facebook has acknowledged that this standard approach would have to make allowance for different companies based on their size and resources, we think that it would disproportionately benefit the largest companies with the correspondingly largest budgets. To us it is an obvious point, but regulators will have to be careful not to increase barriers to entry for smaller competitors as an unintended consequence of their desire to regulate the largest platform.

The other issue is content that is harmful but not necessarily illegal. Studies have shown that conspiracy theories have greater online engagement, which is after all what the social media platforms aspire to generate. Facebook does want to encourage meaningful engagement away from clickbait, but at the same time does not want to engage in censorship and to encroach on free speech.

Facebook's platforms are global on an unprecedented scale for what is after all a US company, and it needs to recognise local cultures and norms as well as comply with rules and regulations. It will be a tightrope act to amend the broad leeway and immunity that Section 230 currently affords, whilst still promoting competition and allowing smaller companies with less resources to also abide by these stricter standards.

Other areas of regulation which could negatively affect the big tech companies are tax, both on the companies themselves and on investors. It is an issue that we think is under-appreciated is the proposed tax reform by President Biden. Increasing the corporation tax rate would increase the low rates currently paid. However, the real issue is the global nature of the businesses and the complexity of global tax regulations. The most recent proposals of a US minimum tax have already been rejected by the EU. Previous proposals have stalled at the national and multi-lateral level, in particular the attempts at alignment of global tax regulation by the OECD. The biggest platforms have the scale to pay increased tax while investing in their businesses and driving growth. They also have the pricing power to pass on increased taxes to users, advertisers, and other customers. As with other regulation the stakes are high and there is potential for unintended consequences that increase barriers to entry and harm innovation and competition.

Of course, on a short-term basis a likely increase in capital gains tax in the US and elsewhere could force some selling from wealthy Americans who wish to realise gains at the lower tax rate. As the big 5 tech companies represent over 20% of the S&P 500, it could also result in forced selling across indices and ETFs. These kinds of fluctuations are opportunities not risks.

Conclusion: Innovation, incentives and opportunity

The technology sector is fast moving with many new technologies and companies appearing. Recent progress has been rapid in areas such as quantum computing, blockchain and crypto, as well as distributed cloud and adaptive machine learning technology. Such rapid progress is a challenge for regulators who are finding it extraordinarily difficult to keep up. The laws that are enacted, such as Section 230, then become out of date and are not fit for the current environment.

We think this challenge is only set to increase. A better solution would be to put the burden on the big tech companies by making them self-regulate. There should be greater incentives for big tech companies to work together as a community to create new standards, for example on Section 230, and to be proactive rather than reactive.

Lessons can also be learned from elsewhere. We have seen significant progress on climate change as large enterprises, encouraged and supported by active and engaged investors, work together with governments to develop the regulatory framework required to achieve the goals of the Paris Agreement. This benefits all of us, and we believe that there should be a similar positive incentive mechanism for big tech when it comes to antitrust regulation, rather than seeing the giants be forced into settlements.

One such suggestion has been for big tech to collectively invest and improve the overall broadband internet infrastructure, with many parts of the world underserved in this basic need. The pandemic has highlighted great inequalities, even in America, with unreliable internet access limiting education, healthcare and work opportunities. It would also create the right incentives for the companies to participate as it would expand their userbase. By agreeing to this, rather than having prolonged negotiations and settlements about takeovers carried out years ago, the big tech companies can put their large resources to use and "do the right thing".

Giles Tulloch

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