Discussion Points

Presented by the *Business at OECD* Competition Committee to the OECD Competition Committee

Barriers to Exit

December 4, 2019

I. Introduction

1. *Business at OECD* appreciates the opportunity to submit these comments to the OECD Competition Committee roundtable on barriers to exit. The Secretariat Note provides a robust discussion of the topic, which we augment with two points: (1) entrepreneurial exit from markets should not be inhibited by regulatory barriers absent significant competition concerns; and (2) barriers to exit through regulatory action by competition agencies through enforcement action should also be considered.

II. Regulatory Barriers and Entrepreneurial Exit

2. Barriers to exit for firms include not only natural marketplace barriers as discussed in the Secretariat note, but also barriers that regulation and enforcement put on firms. That is, in some cases regulation pushes firms to certain kinds of exits rather than others. For example, when there are high regulatory compliance costs to further growth or expansion, smaller firms may conclude that it is preferable to exit the market via sale rather than attempt to overcome these barriers to market participation. They may do so, in part, because founders and investors are looking for a way to exit their investment.

3. There has been some discussion in the policy community about using competition law to forbid larger firms from acquiring small firms as a means of preventing the further growth and influence of large firms and the potential impact of large firms on consumers. A ban on integration, however, is in conflict with the well-accepted recognition of efficiencies.[1] This is particularly true in the case of vertical integration. Further, regulatory history shows that bans on acquisitions can retard economic development.[2]

4. Though framed as a question of "barriers to exit," in fact, the issue specific to acquisition of technology companies is really one of "entrepreneurial fulfillment" or "entrepreneurial success" via exit from the opportunity due to a positive liquidity event. This sort of exit is different from

[1] *See* D. Daniel Sokol, *Vertical Mergers and Entrepreneurial Exit*, 70 FLA. L. REV. 1357 (2018)(providing a literature review). For a review of the efficiency of contractual vertical integration, *see* Francine Lafontaine & Margaret Slade, *Franchising and Exclusive Distribution: Adaptation and Antitrust, in* OXFORD HANDBOOK ON INTERNATIONAL ANTITRUST ECONOMICS VOL. 2 (Roger D. Blair & D. Daniel Sokol, eds., Oxford Univ. Press, 2014).

[2] Christine S. Wilson & Keith Klovers, *The Growing Nostalgia For Past Regulatory Misadventures and the Risk of Repeating These Mistakes With Big Tech*, J. ANTITRUST ENFORCEMENT (forthcoming 2019).

issues like failing firm and other topics covered in the Secretariat Note but is nevertheless an important one to address.

5. At the other end of the spectrum, where companies are not able to continue to compete in the face of a superior market performer, market exit can occur as a result of obsolescence, inefficiency, or consumer preferences. This is a healthy dimension of competition, as highlighted in the Secretariat note. At times, however—rather than stepping up to meet the demands of competition posed by the dominant firm—these smaller firms instead will seek to diminish the dominant firm by seeking out the competition authorities to stop the conduct of the dominant firm even when it does not foreclose competition. Effectively, the strategy is this: if they can't catch the dominant firm themselves, they can still try to use the antitrust authorities to slow them down. This is not to say that competition agencies are naïve or unaware that competitors may have ulterior motives that are not in the best interests of consumers. Indeed, this ulterior motive is well recognized in areas like mergers, where a competitor may complain because they are concerned about the increased efficiency of a rival's merger. Rather, the potential problem is one that stems from the inherent difficulty in discerning when a smaller competitor's failure stems from exclusionary conduct of a dominant firm, and when it stems from other factors that do not violate the competition laws.

Regulatory Impacts on Entrepreneurial Exit in Capital Markets

6. Regulatory constraints can impact exit decisions. In a number of markets, firms exit because of regulatory constraints that impede their ability to grow and that make other types of exits (e.g., via vertical acquisition) far more likely. Such constraints are often found for start-up firms in what competition policy circles sometimes describe as "nascent competitors" related issues.[3]

7. As an example of the consequences of regulatory constraints and the impact on business, since the passage of Sarbanes-Oxley, a law that substantially increased corporate reporting and oversight responsibilities, there have been fewer IPOs in the United States, ever.[4] Sarbanes-Oxley significantly increased compliance costs for public companies in the United States. While the goal of Sarbanes-Oxley was a good one—to improve the quality of audits and reduce company based financial fraud—it had a proportionately more significant impact on smaller firms. Its immediate outcome was clear. Between 2003 and 2004, over 300 U.S. companies delisted their common stock due to Sarbanes-Oxley rather than due to a merger, acquisition, liquidation, registration withdrawal, or going-private transaction.[5]

8. Since passage of Sarbanes-Oxley, the nature of entrepreneurial exit has changed. Because of regulatory costs, it often is advantageous for companies to choose to realize their liquidity event through acquisition rather than IPO. The lack of IPOs impacts competition policy, market structure, and innovation. Traditionally, in the tech boom of the late 1990s, the goal of entrepreneurial exit was an IPO. Today, there are far fewer IPOs in the United States than in prior years.[6] Indeed, between a small number of new listings and an increase in delistings, the number of publicly traded

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3 *See, generally*, Sokol, *Vertical Mergers*, *supra* note 1.

4 William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private*," 55 EMORY L.J. 141 (2006).

5 Christian Leuz, Alexander Triantis & Tracy Yue Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181 (2008).

6 Xiahoui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1663 (2013).

companies is much smaller than it has been historically.[7] As one recent article explains, "[f]rom 1975 to 1996 (the pre-peak period), the number of listed firms increases steadily from 4,775 to 8,025, a cumulative increase of 68%. Since the peak in 1996, listings fall each year from 1997 to 2012 (the post-peak period) and cumulatively decline by 3,923, or 49%, by 2012."[8] Listed company fees, yearly disclosures, and compliance, as well as the IPO process itself, may contribute to this decline.[9]

9. Other work confirms the changing nature of publicly traded firms since the 1990s.[10] Listed companies are older and larger in the modern post-Sarbanes–Oxley regime.[11] In research and development intensive industries, this is particularly true.[12] These factors together show the limits to traditional exit for entrepreneurial firms via IPO.

10. The lack of IPOs has implications for entrepreneurial exit. An IPO allows exit for the early investors in a firm through a public offering of securities. The nature of the securities regime shapes the opportunities for firms to exit through IPOs, but with IPOs now scarce, sales to larger market participants are the default mechanism for entrepreneurial exit.

11. Entrepreneurial exit is critical to a well-functioning entrepreneurial ecosystem, as the possibility of entrepreneurial exit via vertical merger is now the most usual form of liquidity event for founders and venture capitalists. A merger policy that would unduly restrict large tech firms from undertaking acquisitions in industries as diverse as finance, pharmaceuticals, medical devices, hardware, and internet platforms would hurt incentives for innovation in the economy by chilling business formation in start-ups. Increased difficulty for founders and ventures capitalists to exit makes investment in such ventures less likely, since the purpose of such investment is to reap the rewards of scaling a venture to exit.[13] Thus, a general inference that makes acquisitions, particularly in tech, more difficult to approve leads to direct contravention of antitrust's role in promoting competition and innovation.[14] Given that many businesses are built for exit via merger,

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7 Editorial Bd., *Where Have All the Public Companies Gone?*, BLOOMBERG (Apr. 9, 2018), https://www.bloomberg.com/view/articles/2018-04-09/where-have-all-the-u-s-public-companies-gone.

8 Craig Doidge, G. Andrew Karolyi & René M. Stulz, *The U.S. Listing Gap*, 123 J. FIN. ECON. 464, 464, 467 (2017).

9 Brian J. Bushee & Gregory S. Miller, *Investor Relations, Firm Visibility, and Investor Following*, 87:3 ACCT. REV. 867, 870–71 (2012).

10 *See, e.g.*, Kathleen M. Kahle & René M. Stulz, *Is the US Public Corporation in Trouble?*, 31:3 J. ECON. PERSP. 67, 70–71 (2017) (examining the "evolution of US public corporations over the last 40 years").

11 *See id.* at 70–71.

12 *See id.* at 84–85, 86.

13 Harry J. Sapienza, M. Audrey Korsgaard & Daniel P Forbes, *The Self-Determination Motive and Entrepreneurs' Choice of Financing, in* COGNITIVE APPROACHES TO ENTREPRENEURSHIP RESEARCH 105, 106 (Jerome A. Katz & Dean A. Shepherd eds., 2003) ("[W]ealth maximization and self-determination are the two primary motives driving entrepreneurial financing choices."); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 316 (2005) ("Before venture capitalists invest, they plan for exit. That is, they plan to withdraw their investment, adjusted for any return, from the entrepreneur's company. The ability to control exit is crucial to the venture capitalist's business model of short-term funding of nascent business opportunities.").

14 FED. TRADE COMM'N, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY 1 (Oct. 2003), *available at* https://www.ftc.gov/sites/default/files/documents/reports/promote-innovation-proper-balance-competition-and-patent-law-and-policy/innovationrpt.pdf ("Innovation benefits consumers through the development of new and improved goods, services, and processes. An economy's capacity for invention and innovation helps drive its economic growth and the degree to which standards of living increase. Technological breakthroughs such as automobiles, airplanes, the personal computer, the Internet, television, telephones, and modern pharmaceuticals illustrate the power of innovation to increase prosperity and improve the quality of our lives." (internal citation omitted)).

to close off this form of entrepreneurial exit (either by a changed merger inference to prove efficiencies or simply to ban them outright) at a time when the IPO market is at a significant low would chill innovation.

III. Barriers to Exit Through Competition Enforcement

12. At times, competition law enforcement can artificially raise barriers to exit. Less successful firms (often large ones themselves) should exit naturally but do not because they lobby for enforcement by antitrust agencies to larger and more efficient firms. That is, competitor firms that make complaints push antitrust enforcers to take up cases based upon complaints that may not be meritorious.[15] When competition authorities bring cases that benefit competitors and not consumers, such cases may lead to an outcome that may negatively affect business opportunities for the dominant firm, prevent the exit of smaller firms, but have a negative net effect on (at least) total welfare. This risk may be present in several situations, for example where enforcers erroneously block a merger based on perceived anticompetitive effects. But it may also be present in enforcement based on perceived exclusionary conduct by a dominant firm.

13. Enforcement against dominant firms often is precipitated by complaints of smaller rivals, often times by firms that have entered or attempted to enter the market after the dominant firm established its position. The complaints often center around perceived barriers or other exclusionary means erected by the dominant firm that ostensibly have harmed the smaller rival and inhibited their growth. An examination of the market will often reveal a practice that the smaller rival will point to as the central cause of the smaller firm's inability to challenge the dominant firm.

14. Indeed, in some cases, the identified practice may in fact be the precipitating cause of the smaller firm's inability to succeed. And the observable market evidence will often lend itself to such an interpretation: an enforcer would see a questionable practice, a seemingly threatening smaller competitor, and that smaller competitor's inability to capture share in the market. As a result, enforcement against the dominant firm may result, opening the door for the smaller competitor and preventing their exit from the market which otherwise would have, or might have, occurred.

15. The issue, however, is that often times there is little experience with the impact of the challenged practice, such that the competitive effect of the allegedly exclusionary practice is ambiguous. But the observation of the "failure" of the smaller firm can drive a conclusion that the practice must be exclusionary.

16. A proper evaluation of the effect of the practice, however, requires more than evidence that the smaller firm is failing, and sometimes even more than it is "equally efficient." In a concept that is widely cited internationally, U.S. law recognizes that monopolization based on "growth or development as a consequence of a superior product, business acumen, or historic accident" is not unlawful.[16] The same is true for the maintenance of monopoly power. Smaller rivals may not be able to succeed against a dominant firm (that lawfully obtained its dominance) for the same reasons, perhaps even if the smaller firm's product is equivalent or better and even if the smaller firm is equally efficient. Thus, as one leading antitrust jurist stated, "A firm that reduces cost and

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[15] In a number of public choice settings, the principal-agent problem is a result of free-rider problems that exist when a larger group of principals, such as voters, must monitor government agents. *See* M. Albert Vachris, *Federal Antitrust Enforcement: A Principal-Agent Perspective*, 88 PUB. CHOICE 223 (1996) (discussing the relationship between the Antitrust Division of the DOJ and its corresponding congressional oversight committee).

[16] United States v. Grinnell Corp., 384 U.S. 563, 571 (1966).

expands sales injures rivals—sometimes fatally. . . . These injuries to rivals are byproducts of vigorous competition, and the antitrust laws are not balm for rivals' wounds."[17]

17. Thus, in order to ensure that a competition agency's enforcement actions against a dominant firm are not creating an artificial barrier to exit, an agency must carefully analyze the causation of the smaller firm's failure and ensure that there is a direct causal link between the purported exclusionary conduct and the failure of the smaller firm. This requires a critical evaluation not only of the dominant firm's conduct, but also of the smaller firm's initiatives. Merely observing the failure of smaller firms in the market does not suffice to render a practice illegal, unless alternative reasons for the failure of the smaller firms can be reasonably excluded.

18. Of course, some types of anticompetitive actions by dominant firms are not ambiguous and should not be permitted, even when there is no smaller firm on the horizon. Tying and exclusive dealing undertaken by a dominant firm, for example, can have anticompetitive effects irrespective of the potential exit of smaller rivals. But establishing a causal link between the alleged exclusionary conduct and the potential effect on rivals is an indispensable element of establishing harm to competition. Absent such harm, enforcement action can have the effect of raising barriers to exit.

IV. Conclusion

19. While the focus on exit is often on barriers in doctrine and to traditional competitive effects, what is often forgotten is that the ability of firms to exit as part of a liquidity strategy for nascent firms to reward founders and early investors may be impacted by competition policy that views vertical acquisitions of "nascent competitors" with suspicion. However, what may drive such deals are burdens on nascent competitors due to overly aggressive regulatory intervention in financial markets or in privacy regulation. Indeed, the business model of such nascent competitors may be built upon such an exit. In other circumstances, protecting inefficient competitors that misuse antitrust as a form of raising rivals' costs prevents the exit of less efficient competitors.

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[17] Ball Mem'l Hosp., Inc. v. Mut. Hosp. Ins., Inc., 784 F.2d 1325, 1338 (7th Cir. 1986).