

The Digital Markets Unit:

On the Side of
Startups?

An Investor perspective

September 2021



About Coadec

The Coalition for a Digital Economy (Coadec) is an independent advocacy group that serves as the policy voice for Britain's technology-led startups and scaleups.

Coadec was founded in 2010 by Mike Butcher, Editor-at-Large of technology news publisher TechCrunch, and Jeff Lynn, Executive Chairman and Co-Founder of online investment platform Seedrs.

Coadec works across a broad range of policy areas that matter the most to startups and scaleups: Access to Talent, Access to Finance & Technology Regulation. We represent the startup community on the Government's Digital Economy Council, and the UK on the international organisation Allied for Startups Board.

Acknowledgments and Methodology

To develop the recommendations that follow we:

- **Conducted a survey of the UK investor community** to establish their overall view of the UK tech ecosystem and regulatory landscape.¹
- **Held in-depth interviews** with key members of the community to corroborate findings from the survey and build anecdotal evidence.
- **Undertook an in-depth literature review** of key texts both in the UK and in other jurisdictions.

Coadec would like to thank all those who completed the survey and those who gave up their time to share their insights and expertise with us.

¹ The responses to this survey represent the views of expert investors highly or even exclusively concerned with the UK's startup scene. More than 80% of the investors we surveyed dedicated over three quarters of their investing activity to startups, with 67% and 85% respectively engaging in pre-seed and seed investment. 70% were partners, senior partners or Managing Directors in their firm

Executive Summary

Coadec represents the voice of startups, scaleups and the investor community in the UK. Key to their success is competition. The story of startups scaling fast and gaining unicorn status often sees them beating the established players in their field at their own game. From insurance to health, groceries to transport tech startups have upended sectors delivering better outcomes for consumers along the way.

The impact of these startups and scaleups on the wider UK economy also cannot be understated. The UK is widely acknowledged as the tech capital of Europe. 72 of Europe's 162 unicorns were created in the UK and people working in digital tech vastly outnumber those working in financial services (2.1m vs 1.2m respectively) – traditionally seen as the UK's premier industry.

Yet, reforms coming down the road threaten the very foundations this strong performance is built on. The Digital Markets Unit (DMU), the jewel in the crown of the Government's shake-up of digital competition regulation, is moving towards becoming operational next year. While its mission - to rein in the most powerful digital firms, promote greater competition and innovation and protect consumers, is broadly correct, its path to reaching this destination has raised eyebrows in the startup and investor community.

Too much of what the DMU thinks drives innovation relies on blunt instruments to cut down the tech leaders of today rather than actions to ensure new entrants can continue to emerge and grow as the challengers of tomorrow.

The proposed approach to defining strategic market status and mergers and acquisitions on the one hand and blindness to practices impacting B2B markets – a bright spot in the UK's startup ecosystem, hint at a misunderstanding of what startups and their investors need to flourish. However, it is not too late to equip the DMU with the insights and information it needs to ensure that UK startups and scaleups aren't collateral damage to a steamroller approach laser-focused on reining in big tech. With that in mind, Coadec surveyed and spoke to the investor community who have unique insight into the ecosystem.

As the findings in the report demonstrates, they spoke loudly and with one voice coalescing around key issues that the DMU should address as a matter of priority as it moves to becoming operational next year. The recommendations below form part of Coadec's response to the consultation on the DMU launched last month (July 2021).

Key Recommendations

1. **The Digital Markets Unit (DMU) must staff and structure itself to allow for expert and thoughtful engagement with startups, investors and other key actors, ensuring the ‘participative approach’ set out by the Digital Markets Taskforce (‘The Taskforce’) is systematically implemented.** Startups have very limited capacity to engage with policy discussions. Without a concerted effort, the DMU risks creating a fatal blind-spot that could erode the tech ecosystem’s trust in them over time.
2. **Digital Activity must be more clearly defined in the broader definition of Strategic Market Status and interventions by the DMU must be targeted solely at the relevant activity for which Strategic Market Status has been awarded,** removing the ability for the DMU to block or intervene in product design changes elsewhere in the company. The DMU would otherwise become excessively powerful and could stunt innovation and have a damaging effect on consumer outcomes.

3. **The DMU must reconsider lowering the bar to one of “realistic prospect” for interventions into mergers and acquisitions**, this is a legitimate exit route for many startups and scaleups with friction potentially cutting off the lifeblood to the UK’s startup and scaleup ecosystem.
4. **The DMU must limit long and unwieldy investigation processes and abandon the judicial review standard for appeals in M&A cases** in order to restore trust in the competition regulator and ensure the regulators can match the pace of the ecosystem it is seeking to regulate.
5. **The DMU should focus its efforts on identifying and responding to anti-competitive trends and promoting innovation** rather than designing bespoke regimes that will likely proliferate causing confusion and incoherence over time.

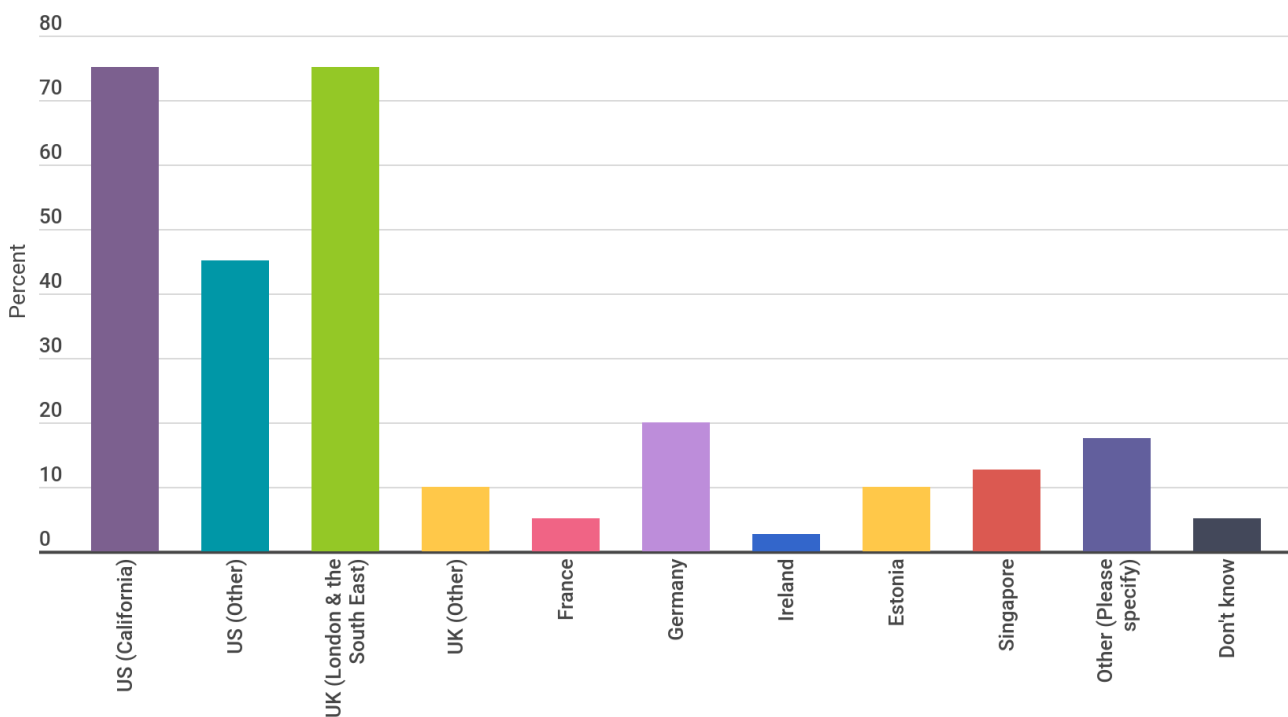
Introduction

Coadec launched in 2010 to focus on the three key policy foundations for startup success: access to talent, capital and a permissive but stable regulatory environment that enable startups to scale, compete and become leading companies. Those fundamentals have not changed in the intervening decade - but the Government's approach to the sector has.

2010 heralded a new dawn for UK tech. East London Tech City (now more commonly known as Silicon Roundabout) was established, putting rocket boosters under London's startup scene and right across the UK new tech hubs flourished creating the right environments for unicorns to emerge. Today there are over 100 UK tech unicorns – more than Germany, France and the Netherlands combined.

This stunning success story is recognised by the investor community who ranked the UK, and in particular London and the Southeast, amongst one of the most attractive destination for startups globally.

Which of the following countries or areas do you think are currently the most attractive as a destination for start-ups? Please select up to three



This success cannot be taken for granted. In that same period regulation has moved from a permissive to a far more restrictive approach. While the focus in the 2010s was on supporting startups and scaleups, the 2020s look set to be dominated by an unrelenting focus on 'taming' a small set of global technology companies. This threatens to leave startups and scaleups, the bedrock of the UK's tech success, as at best an afterthought and at worst collateral damage. Startups are the cradle of innovation – by supporting them through Government-backed initiatives and the right regulatory environment, you breed competition and innovation all the way up the chain.

Take challenger banks such as Starling, Monzo and Revolut, for example, who were able to take advantage of the Second Payment Services Directive (PSD2) and open banking to innovate and disrupt the sector. Not only have they given consumers greater choice in how they bank, but they have also provided the impetus for traditional banks to accelerate their own digital transformations. Challenger banks were the first to recognise consumer appetite for a digitally centred, modular banking experience, and they pioneered the use of apps for customers. In 2011, mobile activity accounted for just 13% of customer banking engagements in Europe² – by 2016, when traditional banking firms across the continent had rushed to copy the online-only challengers, 56% of all customer banking engagements were mobile.

On the other side of that coin, consider Blockbuster – a video-rental chain that once had over 9,000 stores and now only has one – which ironically became the subject of a Netflix documentary this year. Blockbuster was destroyed by its failure to recognise how Netflix was disrupting the video rental industry – not only did it turn down the opportunity to buy Netflix for \$50 million (today is worth over \$40 billion dollars), it failed to keep pace and faded into obscurity.

Innovation comes from new entrants; it provides impetus to incumbents and options for consumers. While Netflix might be in pole position today it and other market leaders know that if they fail to innovate their trajectory may not be dissimilar to others who stars have faded. It follows therefore, that in order to promote a competitive landscape thought must be given to how to support new entrants to start and succeed.

However, conversations on competition policy today tend to centre on the opposite end of the spectrum. Coadec exists to ensure the voice of startups and scaleups is not squeezed out. This paper focuses on proposed changes to UK competition policy in digital markets, recognising the important role competition plays in creating a thriving tech ecosystem. As we've seen startups seek to disrupt. They topple established players, upend markets and offer greater consumer choice. A pro-tech competition regime must enable this to continue.

Done badly, regulation can negatively disrupt a marketplace, pick winners and losers, waste limited resources and cause unintended harms – dampening or killing off innovation across a sector or specific technologies³. Done well, it can bolster innovation and unlock growth (see case study 1). This report makes recommendations about how to do it well.

The decision to establish a DMU within the CMA tasked with creating and enforcing a new competition regime for digital markets is a significant milestone in the UK's journey to reform competition policy. It is a journey that can be traced back to 2018, when the then Chancellor appointed Professor Jason Furman and a panel of experts to explore how the UK's competition framework needed to adapt to keep pace with a fast-moving digital market. The report, which has provided the blueprint for successive governments, recommended the establishment of a DMU to support greater competition and consumer choice in digital markets. The panel advised that the Unit be tasked with the following three functions:

1. Develop a code of competitive conduct for those companies deemed to have 'Strategic Market Status';
2. Enable greater personal data mobility and systems, with open standards as a mechanism for increasing competition and consumer choice; and,
3. Advance *data openness*⁴ to lower the barrier to entry in a digital market while protecting privacy.

2 <https://www.raconteur.net/finance/financial-services/traditional-banking-model-tech/>

3 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/861154/taxonomy-regulatory-types-their-impacts-innovation.pdf

4 Explained as a pro-competition function, data openness can be defined as 'the opening up of a part of a business's legitimately obtained data for the purpose of supporting data-driven innovation.'

The Government accepted all of Furman's recommendations and established a Digital Markets Taskforce to advise on how to practically implement them. The composition of the Taskforce, brought together officials from the CMA, the Office for Communications (Ofcom) and the Information Commissioner's Office (ICO), signalling a growing recognition for the need of cross-regulatory collaboration to offer a more streamlined and coherent approach to "digital issues".

The Taskforce produced its advice to Government in December 2020, and the Government's swift establishment of a DMU in a non-statutory form puts the UK at a critical juncture. With [consultation on the new regime](#) now open on the Government's proposals, this paper asks whether the DMU as currently envisaged can be the pro-innovation and competition regulator its architects want it to be.

The Digital Markets Unit

The Digital Markets Unit has been established within the CMA. It will oversee a new regulatory regime promoting competition and innovation in the digital market on the advice of the Digital Markets Taskforce – made up of the CMA, Ofcom and the ICO.

Although powers for the DMU will require legislation, in the interim the DMU has been established on a non-statutory basis to carry out preparatory work to implement the statutory regime. This includes:

1. Carrying out preparatory work for the implementation of the statutory regime, including building skilled teams and preparing draft guidance.
2. Advising government on the establishment of the statutory regime. For example, the DMU will look at how codes of conduct should regulate the relationship between small businesses and the digital platforms they use to connect with consumers.
3. Gathering evidence on the state of digital markets.
4. Engaging stakeholders across industry, academia, other regulators and government.

"The UK allowed innovation in Fintech, and so we became a kind of FinTech centre ahead of the curve. And partly, that's down to wanting competition against the big challenger banks, which is really smart.. I think the FCA's role here - steps like open banking - was super positive, and should continue."

- An experienced venture capitalist, entrepreneur and Non-executive Director

Case Study 1: FCA's Regulatory Sandbox

The FCA introduced a regulatory sandbox scheme in June 2016 to allow firms to iteratively test innovative services and products in a live market environment with the oversight of regulatory experts from the FCA. 108 firms have participated to date.

The sandbox model has been a success. 75% of the first cohort of June 2016 completed testing by October 2017, and 90% of those firms went on to launch their products in the market. At least 40% of those who completed testing received investment during or following their sandbox tests.

It is also clear that the regulatory expertise offered by the sandbox has helped applicants, and participating firms have reported that the programme offers them a way of immediately building rigorous consumer safeguards into their services, as well as gaining credibility in the eyes of potential investors and customers. For smaller companies, the sandbox allowed them to test the technology and commercial viability of their products.

Nuggets - an ID and payment platform that took part in September 2018 - reported that the sandbox "levels the playing field between incumbents and startups, by allowing smaller firms to get up to speed with financial regulation and think about their business models as much as their innovation." Some participants in the sandbox have gone on to enjoy great success - Zilch, a member of the fifth cohort (Q2-3 of 2018) has just closed an \$80m Series B funding round, taking its total valuation to \$500m. The sandbox has been so successful that other regulators like the ICO have followed suit, launching their own sandbox in September 2019.

"Sandboxes are the best regulatory practice we have at the moment. Sandboxes are great because they give startups a sort of visible window through which to enter."

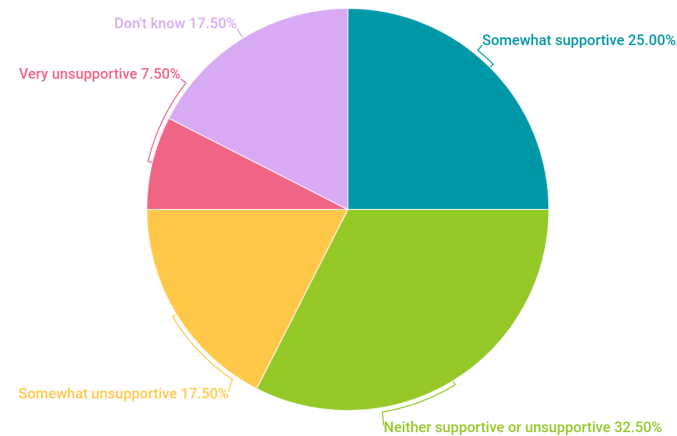
- A Venture Capital policy expert

RECOMMENDATION ONE

The Digital Markets Unit (DMU) must staff and structure itself to allow for expert and thoughtful engagement with startups, investors and other key actors, ensuring the 'participative approach' set out by the Digital Markets Taskforce ('The Taskforce') is systematically implemented. Startups have a very limited capacity to engage with policy discussions. Without a concerted effort, the DMU risks creating a fatal blind-spot that could erode the tech ecosystem's trust in them over time.

The DMU has been handed a challenging brief. It enters the ring at a difficult moment with a proliferation of other legislative and regulatory initiatives in the digital space. Early engagement with those who make the tech ecosystem in the UK what it is today will be key and yet our survey reveals that investors generally believe that competition policy either has little relevance to startups or is in fact actively working against them.

From the perspective of the businesses you work with, do you think the current rules for competition policy generally are supportive or unsupportive of the start-up ecosystem?

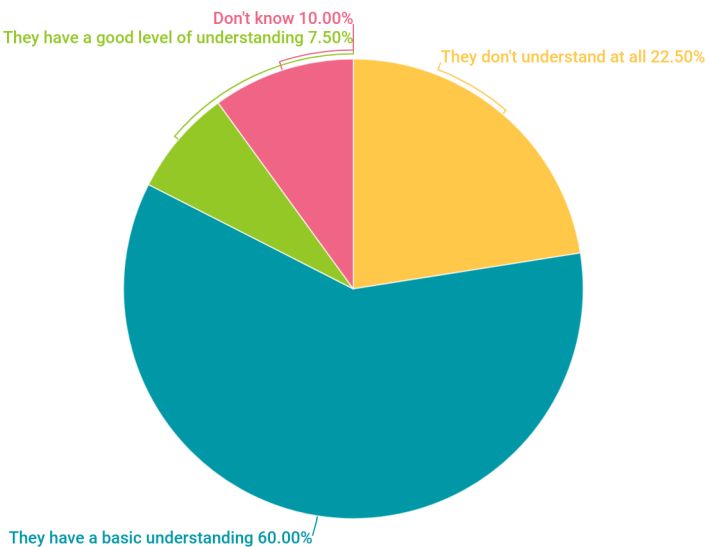


Additionally, when asked if regulators had a good understanding of the overall startup market, 60% of those we spoke to thought they only had a “basic understanding”, with almost a quarter responding that they didn’t think regulators understood the startup market at all.

Clearly, there is much work to be done to reassure the community that UK regulators are well-informed and are listening to their concerns. Having the right mix of talents and the right structures in place will be key, not only as the DMU gets off the ground but as it is required to keep pace with the tech sector.

This is not a new challenge, the last decade has seen regulators attempt to keep up with technologies with varying levels of success. For example, the dawn of autonomous vehicles necessitated the establishment of the Centre for Connected and Autonomous Vehicles (CCAV) in 2015 to develop regulation and ensure it can pave the way for self-driving vehicles to take to UK roads. These regulatory challenges require the regulators themselves to become more responsive and agile (as per case study 2). All too often, however, this has either been limited to very specific areas such as Financial Services or has simply involved taking a macro-view by examining technology trends and their impact on the economy more broadly.

How good an understanding do you think regulators have of the overall start up market?



Case Study 2: Keeping pace

Dubai's Financial Services Authority has developed its own 'regtech' in-house to help it build more sophisticated risk management systems. Singapore, similarly, has created a Centre for Strategic Futures which sits inside the Prime Minister's Office and offers greater foresight to regulators, helping to build capacity to meet future trends. The UK, too, has embraced the 'regulator pioneer' model through its fund to support bodies to create a regulatory environment that gives innovative businesses the confidence to invest.

Given the DMU's broad remit and the potential for mission creep, discussed further in the report, it is vital that the foundations are strong. The right structures, processes and staff will be key to plotting a successful course in what are undoubtedly choppy waters.

First, the CMA must build a team that enables it to meet its aspirations of turning the DMU into "a centre of expertise for digital markets, with the capability to understand the business models of digital firms, including the role of data and the incentives driving how these firms operate."⁵ This must be reflected in the budget eventually allocated to the DMU, allowing it to compete with those hiring for regulatory experts in the technology sector itself. [The Impact Assessment](#) published alongside the Consultation on a new pro-competition regime for digital markets suggests a "potential annual cost of the DMU...between £5m and £25m per annum" if it is designed as laid out in policy option 3 – Government's preferred option.⁶ To put it into context - Ofcom's budget for the financial year 2020/21 is £131.9m and the FCA budgeted £15 million solely to help them and the UK financial services industry prepare for the end of the transition period on 31 December 2020. We would argue that the minimum budget for the DMU should therefore be £20 million with a view to increasing this significantly if deemed necessary by the leadership.

It is positive that the CMA has already identified the recruitment and retention of staff as central to its ability to successfully discharge its mission. This has been a common and long-standing concern from all those that engage with UK regulators on technical issues in the digital sphere. A failure to build internal expertise and capacity will stunt the DMU's ability to act and leave it reliant on third-party insight.

Second, the DMU must structure itself in a way that enables a whole-ecosystem approach. The Taskforce recommended that the DMU take a 'participative approach' in both the designation of SMS on a firm and in resolving concerns. The genesis of this approach can be traced back to an interview with Professor Jean Tirole, where he introduced the concept of "participative antitrust" whereby "industry or other parties propose possible regulations and the antitrust authorities issuesomeopinion, creating some legal certainty without casting the rules in stone."⁷ The problem is that there is little detail of how this might actually work in practice. The Taskforce leaves it for the "DMU to decide when it is appropriate to rely on engagement, balancing the wider compliance and deterrence effect an investigation may have, with the potential efficiency benefits of informal resolution".

5 https://assets.publishing.service.gov.uk/media/5fce7567e90e07562f98286c/Digital_Taskforce_-_Advice.pdf

6 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1003915/DMU_Impact_Assessment.pdf

7 <https://qz.com/1310266/nobel-winning-economist-jean-tirole-on-how-to-regulate-tech-monopolies/>

The pathway from informal engagement to the use of formal powers must be set out clearly to offer startups, investors and others in the community more certainty about how and when to engage. Without clear criteria and roadmaps for escalation, startups and those whose resources are stretched or non-existent may be deterred from engagement that is perceived hollow and without structure.

This is particularly dangerous for the startup community who have very limited capacity or resources to engage with policy discussions even where they will likely later feel the impacts. This potentially leaves the DMU with a hole in their thinking and a skewed vision of UK's tech ecosystem. This blind-spot could erode trust in the ability of the DMU over time and may deter investment into the UK given the importance of the issues at stake should the DMU's remit remain unchanged.

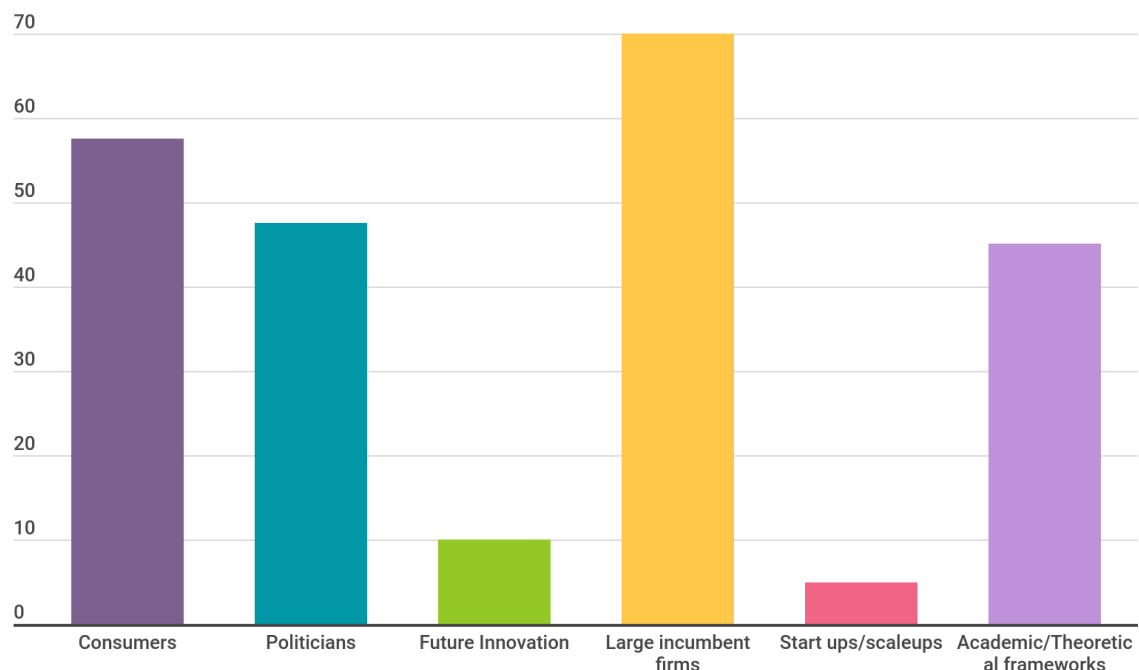
"Most startups most of the time, don't look at regulation until there's a thing in front of them, and they are not great at engaging in consultations etc. It is very difficult to persuade them to engage in that stuff in the kind of sensible way that those of us who work in public policy know needs to be done, they just don't have the capacity"

- A patient venture investor

Finally, the DMU must jealously guard its independence. The Taskforce recommends the establishment of a 'group of expert advisors' for short, fixed periods of time to work on "particular issues". A longer-term expert advisory board who can offer strategic direction and ensure a diversity of perspectives are heard is far preferable.

Our survey shows that there is already a perception that startups are bottom of the pile when regulators consider the design of competition rules. Investors believe that regulators give far greater consideration to politicians, incumbents, and academic frameworks than they do to future innovation and startups. This cannot be allowed to continue if competition policy is to fulfil its goal of helping to engineer the UK's ongoing tech boom. Exacerbating this disregard of startups by creating open channels of dialogue with SMS firms may only serve to widen that perception gap, painting an inaccurate but equally harmful picture of the UK to startups and founders alike.

Who or what do you think regulators have most in mind when they design competition rules? Please tick up to three



We recommend a more permanent group is established with teeth to ensure greater transparency, accountability and to ensure participative approaches are inclusive and holistic. Moreover, given that the DMU's 'to-do' list will grow between now its launch in 2022, such a body could act to steer the DMU and support its priority-setting.

By ensuring that the DMU has the right operational team – staff with the right mix of skills, expertise and experience, and a governance structure that ensures a diversity of voices are accounted for - it remains a possibility that the DMU becomes an effective and well-targeted regulator within the CMA despite its bloated brief on paper.

RECOMMENDATION TWO

Digital Activity must be more clearly defined in the broader definition of Strategic Market Status and interventions by the DMU must be targeted solely at the relevant activity for which Strategic Market Status has been awarded, removing the ability for the DMU to block or intervene in product design changes elsewhere in the company. The DMU would otherwise become excessively powerful and could stunt innovation and have a damaging effect on consumer outcomes.

Definition of Strategic Market Status

The Digital Market Taskforce defines Strategic Market Status as a firm that has substantial, entrenched market power in at least one digital activity, providing the firm with a strategic position.”

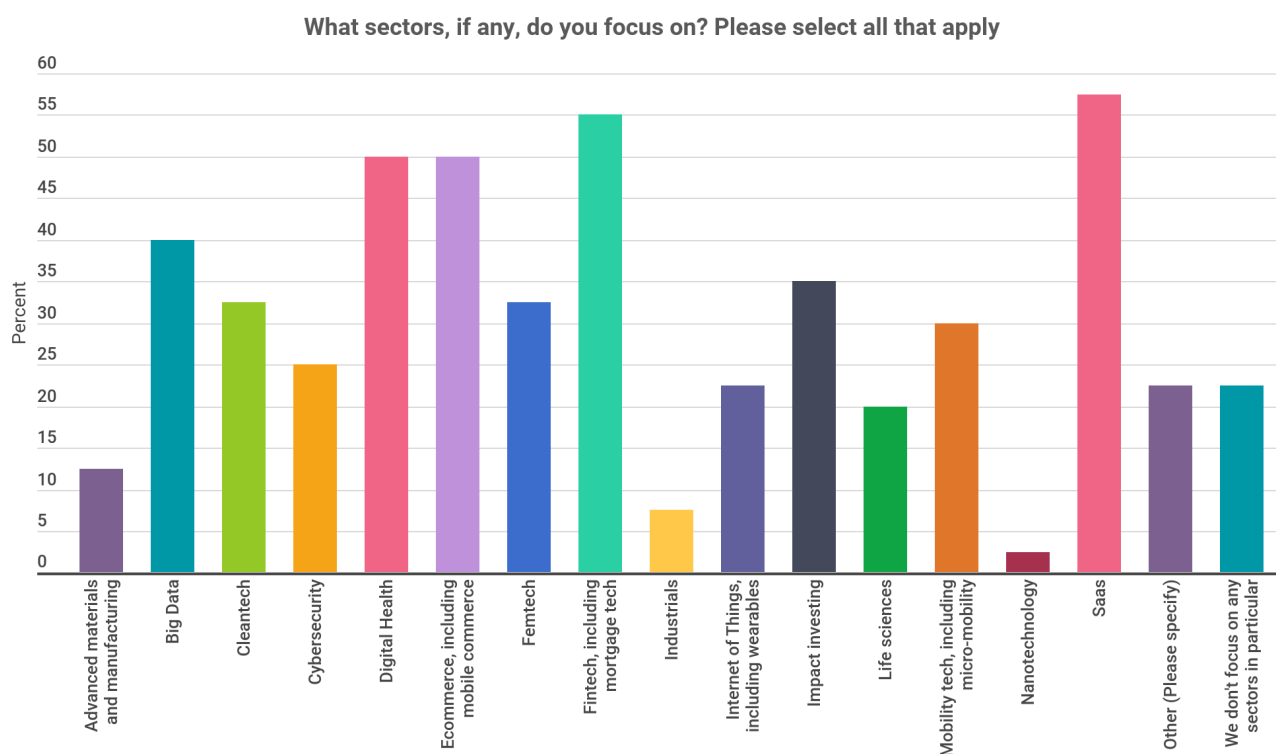
The investors we spoke to for this research have diverse portfolios spanning cybersecurity to fem-tech and micro-mobility. All the businesses they support could be impacted either directly or indirectly by the DMU’s proposed approach to SMS. Yet, most of the debate about the DMU and its remit has focused on the big tech companies, and even more specifically on platforms. Google and Facebook will almost certainly be classified as having ‘Strategic Market Status’ (SMS), and it is quite likely that Uber, Microsoft, and Amazon will too. However, in a digitising economy the definition of SMS, specifically mention of “one digital activity” leaves it open to cast a far wider net across the economy. Digital technology will not be boxed into a neat vertical - companies in sectors as varied as groceries and transport will eventually fit the SMS definition as they digitise.

This will make the DMU a powerful whole-economy regulator with an almost unlimited number of large companies under its watchful eye.⁸ This is recognised in the latest consultation on the new competition regime – “our view is that this could make the scope of the regime too broad and provide insufficient clarity for stakeholders”. Nevertheless, the proposed alternative, introducing the idea that digital must form a “core component” of the products and services provided as part of the activity that is being assessed for SMS, is similarly short-sighted. Government should be encouraging companies to make digital a core component right across their business – making use of data analytics, cloud computing, AI and other productivity-boosting technologies.

Beyond this top-line issue of definitions however, there are deeper concerns. Once given SMS status, the DMU will have extraordinary powers over the company, essentially giving them a say on a range of core business decisions. The advice from the Taskforce is that “a firm cannot make changes to non-designated activities that further entrench the position of its designated activity unless the change can be shown to benefit customers”. In other words, almost any activity could be covered. This is even though the Taskforce recognised that a broad application could have significant adverse effects, for example, an SMS firm may be a disruptive entrant into areas outside of its designated activities.

This contradictory position is highly damaging. No clarity has been offered on how a test of “beneficial to customers” would be applied or judged.

8 There is no clear process by which SMS is withdrawn making it likely that the list will only grow with time.



A huge number of the startups in the UK are applying digital approaches to traditional sectors or component activities – they are disrupting banks, insurance, pharmaceuticals, law, human resources, logistics and operations. These are the sectors and horizontals that could increasingly be covered by this new regulator.

Many of those startups will exit through acquisition – large companies will buy their technology to improve their own operations. As we discuss further below, exit through acquisition is a legitimate and often favoured route for startups and their investors. It allows founders and investors to make a return, and often to re-invest elsewhere or start a new company. The threat of SMS status because of digitisation of an activity, could narrow the pool of businesses willing and able to acquire innovative but niche startups. This could mean fewer startups across the economy – the very challengers and disruptors that play a key part in driving growth and innovation in the UK.

Similarly, for investors looking to diversify their portfolios, the ability for the DMU to reach right across the economy and badge firms as having SMS could have a chilling effect. Already, our survey data shows that 60% of the community we spoke to felt that the current regulatory system is bad at reducing uncertainty. Yet, the process for designating a business as having SMS is likely to take 12 months – a long time for startups and investors to cope with high uncertainty which may discourage innovation and investment., two key drivers of competition.

“You need a competitive market and a lot of competition comes from new entrants, that is what is driving innovation in tech – new entrants. And the UK is full of early adopters making it an ideal location to start and scale a business in any sector that can be disrupted by tech.”

– Investor, entrepreneur and startup supporter

RECOMMENDATION THREE

The DMU must reconsider lowering the bar to one of “realistic prospect” for interventions into mergers and acquisitions, this is a legitimate exit route for many start-ups and scale-ups with friction potentially cutting off the lifeblood to the UK’s startup and scaleup ecosystem

Academic evidence suggests that the rules on acquisitions have a tangible impact on the flow of capital. States and countries with liberal rules on takeover see VC levels up to 30%-50% higher than those that don’t. We estimate conservatively that the Government’s proposals could create a £2.2bn drop in venture capital going into the UK. This, in turn, could ultimately reduce UK economic growth by £770m.

Our survey confirmed this - when asked, 90% of the UK’s investors we surveyed told us the ability to be acquired is very important to the startup ecosystem – with the other 10% claiming it was somewhat important. Perhaps even more tellingly, half of the investor community that we spoke to said that a restriction on the ability to exit would have a significant impact on their future investment decisions, leading them to significantly reduce the amount they invest in the UK startups.

Yet, The Taskforce propose to all but close this avenue to exit. The Taskforce proposes changing the rules to enable closer scrutiny of mergers and acquisitions involving SMS firms. In their advice, the Taskforce recognises the importance of M&A activity to the business models of large incumbents but fails to understand that this importance is mirrored in what they term ‘acquisition targets’ – otherwise known as the startup and scaleup ecosystem of Great Britain.

Currently, the CMA can involve itself in a merger or acquisition on balance of probabilities - i.e, where there is a greater than 50% likelihood that an acquisition would lead to a substantial lessening of competition (SLC). The DMU proposes lowering this bar for firms with SMS by introducing a new test - one of a ‘realistic prospect’. This lower bar demonstrates the mission creep Parliament should be fearful of, as it effectively hands powers to the CMA to block any acquisition that can be deemed as having a realistic prospect of harming competition. Here the CMA goes further than proposals made by the Digital Competition Expert Panel chaired by Professor Furman, which recommended a change in legislation to introduce a “balance of harms” approach that would consider the scale as well as the likelihood of harm in merger cases. In the words of the panel, “this change would move these merger decisions to a more economically rational basis, and allow big impacts with a credible and plausible prospect of occurring to be taken properly into account”.⁹ Choosing to lower the bar further than this threatens the foundations of the tech ecosystem.

9 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785547/unlocking_digital_competition_furman_review_web.pdf

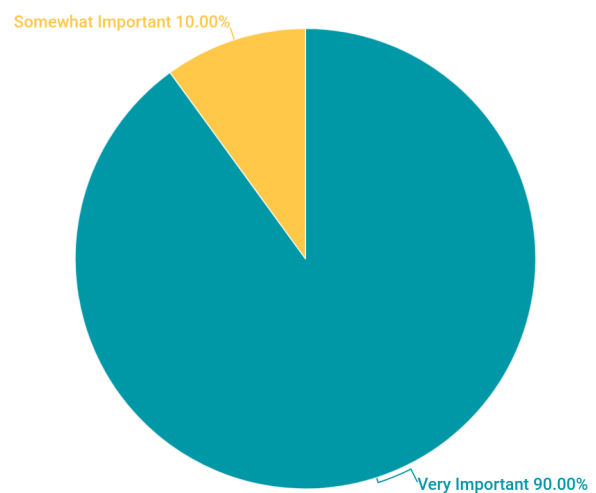
The role acquisition plays in the startup ecosystem

No Founder embarks on their startup journey with small ambitions. They and their investors believe they have the next big idea and for most the dream is an IPO. The reality is for those who succeed (a very slim proportion of startups) acquisition is a far more likely outcome. In the US in 2018, for example, 85 venture-backed companies went public, whereas 799, or nearly ten times as many, were acquired.¹⁰

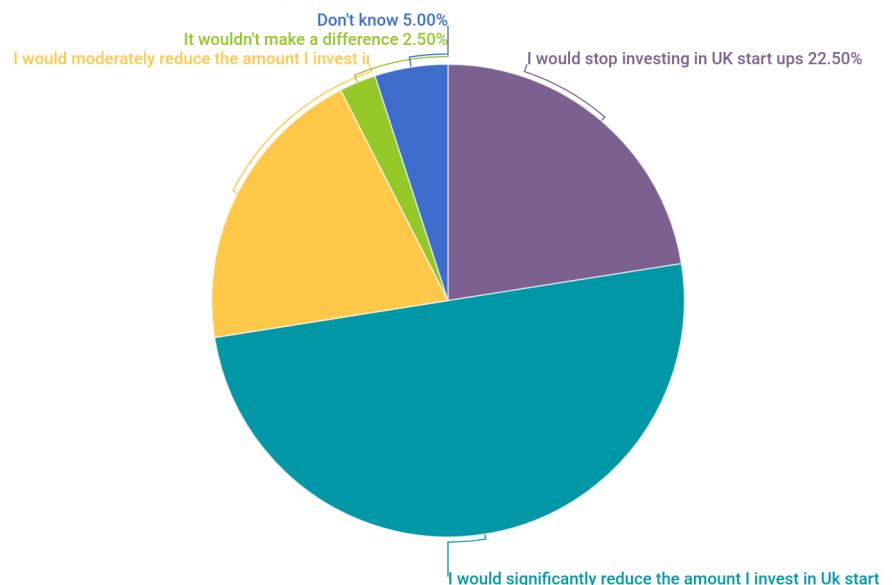
Exits allow venture firms and investors to raise a new fund for future investment and invest in the next generation of companies. The same is true with Founders who often go on to other projects. There is statistical evidence that shows that Founders who exited in the past have a higher chance of going public.

This circular ecosystem which plays a critical role in driving growth and innovation relies on incumbents with the necessary resources to innovate by acquisition. If they are prevented from doing so by new M&A rules then that circle is broken with huge unintended consequences to the UK's thriving ecosystem.

How important or unimportant, in your view, is the ability of startups to be acquired to the success of the overall tech startup ecosystem?



What impact, do you think, would a significant restriction on the ability to exit have on your future investment decisions with regards to investing in UK startups?



RECOMMENDATION FOUR

The DMU must limit long and unwieldy investigation processes and abandon the judicial review standard for appeals in M&A cases in order to restore trust in the competition regulator and ensure the regulators can match the pace of the ecosystem it is seeking to regulate.

The Furman Review was published in March 2019. That year, 8.7% of the UK's smartphone population was using TikTok - that has increased to 13.3% in 2021, and TikTok users in the UK have almost doubled the time they spent using the app from an average of 11.0 hours a month in 2019 to 19.9 hours in 2020¹¹, putting TikTok ahead of Facebook and other apps in its family – Instagram, Whatsapp and Facebook Messenger.¹² Yet, whilst Facebook is mentioned 71 times in the Furman review, TikTok gets a grand total of zero mentions. Even in December 2020 The Taskforce failed to mention TikTok.

In other words, in the tech world, policy dates, and fast. This was recognised as an issue by former Chairman of the CMA, Andrew Tyrie, who lamented that “just as the pace of change in markets is accelerating, the competition framework is taking ever longer to get results. In the time it takes to reach a decision and go through the appeals process, markets may move on. The detriment will be developing somewhere else.”¹³

As discussed in the introduction, this issue of keeping pace has prompted a review of competition regulation, but a related additional issue is the length of antitrust investigations themselves. One of the most flagrant examples of this is the Google Shopping search results case that began over a decade ago and has yet to be resolved, with Google currently appealing a €2.4bn fine. Whilst this is an extreme case, a report from the European Court of Auditors found that antitrust cases took an average of four years to come to a conclusion. Whilst the CMA has a statutory period of 24 weeks to conduct its investigation and publish a report, in reality investigations last far longer. On average, the period from the opening of the investigation to the date when the OFT or CMA adopted an infringement decision lasted approximately 29 months.¹⁴ This increases once appeals are accounted for. For example, a CMA investigation into alleged excessive and unfair prices for phenytoin sodium capsules opened in May 2013 and remains unresolved today – eight years on.

¹¹ <https://www.appannie.com/en/go/state-of-mobile-2021/>

¹² Statistics are for Android users – State of Mobile report

¹³ <https://www.gov.uk/government/speeches/is-competition-enough-competition-for-consumers-on-behalf-of-consumers>

¹⁴ https://www.oxera.com/insights/agenda/articles/are-competition-appeals-taking-too-long/#_ftn7

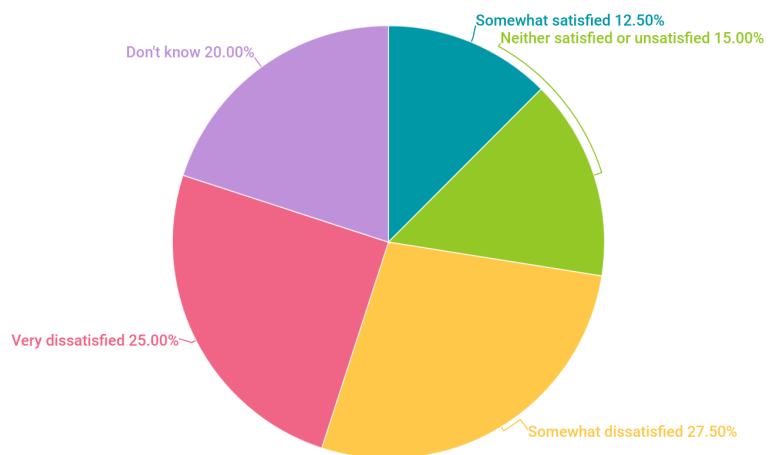
This has unintended consequences for the startups and investors operating in that ecosystem, with the uncertainty causing nervousness and essentially freezing investment decisions. 73% of respondents to our survey felt that regulators were bad at making fast decisions and 60% reported that the speed of regulatory decisions had an impact on their businesses or the startups they invested in. As the shadow DMU prepares to become operational it must focus on ensuring that thoroughness is matched with speed so as not to add a further layer of disruption and friction to startup growth.

Moreover, the CMA has stated that it “will also begin work to develop guidance on how the DMU will exercise its powers... for example procedural guidance on the DMU’s approach to code breach investigations and penalties.”¹⁵

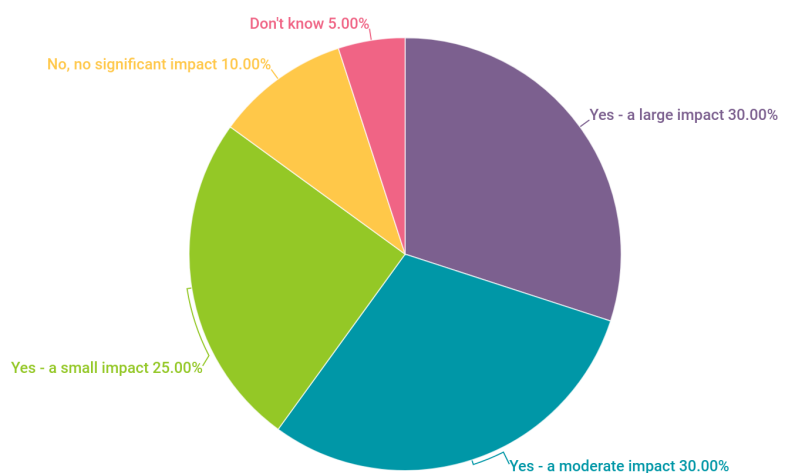
Much of this is being done through the consultation on *Reforming Competition and Consumer Policy* which we welcome. This is an opportunity to examine its investigation and appeals processes more broadly.

The Taskforce advised that decisions made by the DMU on designation and code breaches could be appealed, but they followed the CMA’s current mould by suggesting that a ‘judicial review’ threshold should be applied. This requires that an appellant believes the decision was illegal and was determined due to procedural unfairness or irrationality. The lack of clarity on the DMU’s mission and scope potentially means that any appeals process that relies on this high threshold being met is essentially inaccessible. Analysis by Linklaters showed that “the chances of receiving an adverse CMA decision are higher now than they have been at any point during the last ten years”.¹⁶ All this contributes to creating a less attractive environment for investors who are put off by lengthy investigations, activist regulators and unnavigable processes and governance structures.

How satisfied are you with the speed with which UK regulators currently take decisions related to tech startups?



Does the speed of regulatory decisions have a significant impact on your business, or the start ups you invest in?



¹⁵ <https://www.gov.uk/government/publications/competition-and-markets-authoritys-digital-markets-strategy/the-cmas-digital-markets-strategy-february-2021-refresh>

¹⁶ <https://www.inhouselawyer.co.uk/legal-briefing/appealing-a-decision-by-the-cma-in-a-merger-review/>

RECOMMENDATION FIVE

The DMU should focus its efforts on identifying and responding to anti-competitive trends and promoting innovation rather than designing bespoke regimes that will likely proliferate causing confusion and incoherence over time.

The Digital Markets Taskforce has argued that part of the reason regulation has not been able to keep up is that the existing tools are poorly placed to address the issues raised by digital markets. They argue that these tools “are too slow...backward looking and case-specific, and are largely static, one-time interventions focused on addressing past poor conduct”. The remedy suggested is an ex-ante regime whereby those firms designated as having SMS will be required to follow a Code of Conduct for the designated activities that led to that firm being awarded SMS. The Taskforce, in its advice to Government, argue that this principles-based approach will shape behaviour, thereby avoiding the emergence of problems in the first place, and allow for more rapid action when problematic behaviour is detected.

The Taskforce proposes that the content of the Code be tailored for each firm based on its activities and business model under three, legislated-for objectives: fair trading, open choices, trust and transparency. In its advice, the Taskforce argues that “setting the objectives in legislation would mean they were much harder to change than if the DMU developed them, but for that reason would provide greater predictability at the outset”.¹⁷

However, the principles and guidance that sit under these high-level objectives offer no predictability at all. For example, principles and guidance can be adjusted over time, and the DMU can provide ‘exemptions’ to those governed by the Code. This lack of clarity and the unpredictable nature of how Codes of Conduct will be written and applied is not only detrimental to the firms given SMS but also the wider ecosystems they operate in.

For a firm with SMS, an opaque Code of Conduct could act as a handbrake on innovating with startups. SMS firms may be unsure whether a certain product change or acquisition could leave them falling foul of the Code of Conduct, delaying, or even acting as a block to innovation or investment. Even more worrying, however, is the potential chilling effect such uncertainty brings to high growth companies or innovative companies seeking exit through acquisition. Despite not having ‘SMS’, these firms may feel the impact indirectly, either by forcing them to make decisions based on potential designation or by pulling themselves into line with a SMS designated firm to ease the route to acquisition. This trickle-down effect could impact investment, innovation and lead to poorer outcomes for consumers. However, many of these losses and negative outcomes will be near-on invisible, and with no clear metrics for determining the success of the Codes of Conduct it is unlikely that these unintended consequences will be addressed.

¹⁷ https://assets.publishing.service.gov.uk/media/5fce7567e90e07562f98286c/Digital_Taskforce_-_Advice.pdf

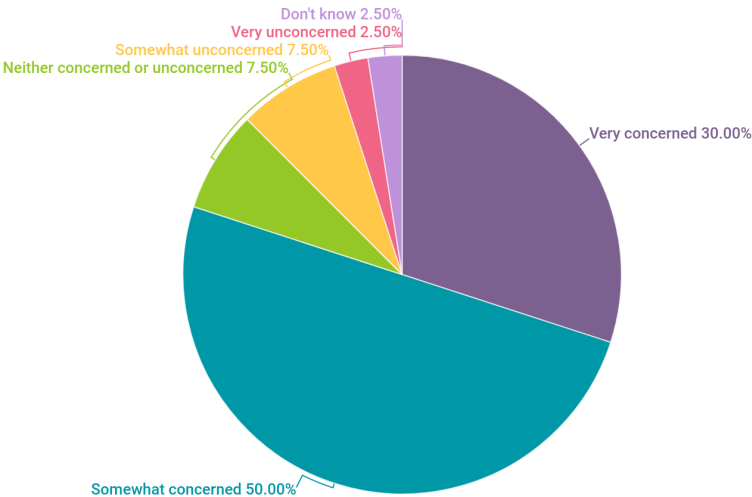
We recommend the DMU takes a different approach – one that looks at specific practices rather than principles, as the CMA did with its market study into digital advertising. That report, published last year after a comprehensive phase of evidence gathering and research, provides a template that the DMU could build on.

The Market Study was broadly welcomed because of the process it engaged in, taking three high-level issues and working in close cooperation with a range of firms to study the ecosystem in significant detail and make recommendations. The final report was the culmination of an intensive year-long review and saw extensive consultation with numerous stakeholders.

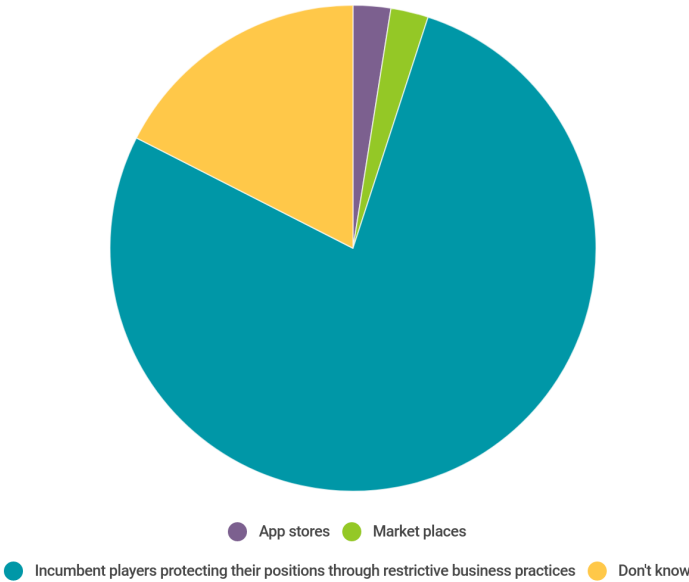
This same process could be applied to another area where there is cause for concern. One area that to date has not had the attention it deserves is B2B software licensing and potentially uncompetitive practices that entrench incumbents.

This of particular concern in the UK where the average startup is a B2B SaaS company. 52.% of investors surveyed focus on SaaS. This is an area that is and will continue to experience significant growth as more businesses and the public sector move to a cloud-first approach. Responding to this busier marketplace, legacy software providers are erecting technical, contractual and financial barriers to effectively lock out disruptors and innovators. As many as 80% of investors are concerned about incumbents raising barriers to new entrants in this manner, and 77.5% believe that changes to the ability of incumbents to protect their positions in this way would be a key way to positively impact the startups in their portfolio.

How concerned or unconcerned are you about incumbent companies making it harder for new entrants to break into markets?



From the following, what do you think the start-ups in your portfolio would be most positively impacted by changes to the power of?



These practices act as a drag on the economy by preventing businesses from making efficiencies through innovative practices and services. They pour cold water on innovation by making it harder for startups to win new customers and create products that integrate seamlessly.

This issue has been discussed extensively in academic literature and has gained more attention in reports commissioned both in the UK and internationally. Furman briefly mentioned the practice: “where multi-market firms hold a strategic gateway position in one market, they are then able to leverage that position in adjacent markets, give themselves an advantage through self-preferencing, and obtain an unfair advantage through holding of data and imitation of rivals’ innovations.” The CMA’s market study looked at the issue but did so only through the narrow lens of Google and Facebook’s practices, whilst the European Commission’s report - Competition Policy for the Digital Era, provided the foundations that have become the Digital Markets Act with provisions to address the market power of ‘gatekeepers’.

These previous reports lay the ground for an in-depth examination of the issues by the DMU once instituted and present a more targeted approach that relies on engagement and building a strong evidence base. This approach, rather than one of ever-changing principles, gives greater certainty and has the potential to be more effective in tackling anti-competitive practices across an ecosystem rather than picking off firms one by one.

Finally, the DMU should be given an explicit mission to promote innovation. The Consultation on the future regime proposes not making this explicit stating that “we do not currently consider it necessary to explicitly include innovation in the DMU’s core duties, given that it is already encompassed by competition”. However, earlier in the same document it suggests that it will boost innovation by “tackling the sources of existing and future strategic market power”.

This negative framing fails to recognise startups as the beating heart of UK innovation and instead again falls back on restricting the incumbents and even future giants. We believe an explicit mission to promote innovation would support a dialogue with startups whose needs otherwise may go unheeded.

“We need people in there specifically thinking about how to promote innovation, that is where the real prize is”

- Investment Manager

