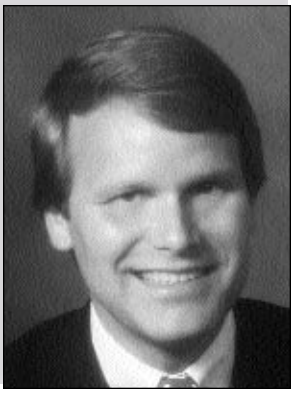
INDUSTRY TRENDS

Microsoft Ruling Suggests Old Anti-Trust Laws Are Not In Tune With The New Economy



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Over the past decade, few would argue that we have been in the most dynamic economic environment ever and that it is in large part a function of a technological revolution that forever has changed global commerce. Between 1990 and 1999, the share of U.S. households with personal computers rose from 22% to 53%, annual U.S. shipments of personal computers increased from 9 million to 43 million. Households with internet access went from 0% to 38%, total global web sites grew from 313,000 to 56 million, sales by U.S. software firms went from $63 billion to $141 billion. A recent White House conference credited the new economy's technological advances for raising living standards, increasing productivity, reducing inflation and possibly weakening the downside effect of the business cycle.

Yet, with all the extraordinary dynamics attributable to this technological revolution, it is very difficult to separate Microsoft from this larger economic transformation of global commerce. Microsoft's central contribution was (and is) standardization. This meant that application programs from spreadsheets to photo processing didn't have to be written in multitudes of operating systems. Software markets expanded, so writing programs became more profitable. Computer networks could be more easily constructed. People who learned computer skills at one company wouldn't lose them by moving to another. For most technologies, standards are vital. Without standards, price could not be driven down, more people would not have gained access to technology and technology would not have emerged as a significant economic driver; but most importantly, without standards, mass markets are not possible.

Microsoft, in effect, standardized technology which made its global acceptance possible. Microsoft and the emergence of the new economy are one and the same phenomena and thus one of today's most intriguing contradictions. How can the White House tout the wonders of the new economy while the Justice Department is characterizing Microsoft as being anti-competitive? If Microsoft is so anti-competitive, how is it the new economy is so competitive that productivity increases while inflation is reduced?

The evils of monopoly that restricted supply and drove up prices combated by anti-trust laws, do not come into play with the Microsoft allegations. The check on Microsoft's dominance is new technology. Today's significant competition doesn't come from identical products sparring over price as envisioned by the Sherman Anti-Trust Act of 1890. Today's most significant competition involves rival technologies struggling for superiority. Wireless communication competes with land lines. The Linux operating system is beginning to challenge Microsoft's windows.

Indeed, Judge Thomas Penfield Jackson does not suggest that Microsoft has used illegal means to achieve its market position? He dismissed the Justice Department's allegations that Microsoft's exclusive contracts with key partners (such as computer makers and internet service providers) foreclosed the market for Netscape's browser software, noting that Netscape shipped 160 million copies of their browser software in 1998. The focus of the Justice Department's contention is what they characterize as the illegal tact of "tying" when Microsoft bundled its internet browser software with its Windows operating system. Netscape feels this is an unfair predatory tactic that severely limited the market for Netscape's browser. The Appeals Court ruled that Microsoft could evade charges of "tying" and an earlier consent degree, if it could show a plausible benefit to consumers for integrating the products. Thus, Microsoft simply had to illustrate that it could charge less for products and make them easier to use for consumers by bundling, rather than unbundling, them. But in a highly unusual move, Judge Jackson disagreed that he was bound by the Superior Court ruling. Judge Jackson has not only ignored an Appellate Court but has ignored relevant Supreme Court rulings on such matters. The Supreme Court has ruled that an *attempt* to restrain trade is not the same as restraining trade. So, assuming the Justice Department's allegations are correct, only if

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sors (the duality of the standards), an effective practice should treat every client engagement as a fiduciary relationship. When adopting such an approach, the advisor should structure services that are horizontally and vertically integrated., as seen in Figure 1. The horizontal axis illustrates that services should be developed that are as applicable to private trusts (family wealth) as they are to retirement plans. Likewise, the services should be vertically integrated. The same investment process should be provided whether a client has $100 thousand, $100 million or $1 billion, with the primary difference between the services being retail accounts would ordinarily be implemented with mutual funds, institutional accounts with separate account managers, and middle market accounts ($5- $100 million) with a combination of funds and managers.

The horizontal and vertical integration of services (Figure 1) enables the advisor to apply a consistent process for every client, thereby ensuring that fiduciary standards are effectively met. This approach has the additional benefit of providing for greater efficiency as (1) the advisor can service a greater range of clients with one comprehensive servicing platform and, (2) the probability of procedural errors and omissions is dramatically reduced when an advisor has one comprehensive investment process that is consistently applied to every client engagement. That's not to say that every client receives the same cookie-cutter solution, but rather every client experiences the same investment management process.

Figure 1.
Vertical and Horizontal Integration

The role of the investment advisor has not been diminished with the advent of cyber-advice. It has, however, put pressure on the advisor to ferret out new ways to be more effective and efficient in the delivery of an investment process. An effective-efficient investment management goes hand-in-hand. An efficient process that does not effectively fulfill fiduciary and/or professional standards of care eventually leads to higher client turnover and/or increased professional liability. Likewise, the advisor that provides effective services but does not incorporate any efficiency in the process will not be able to build a profitable business. ■

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Netscape had actually restrained trade at Microsoft's request would Microsoft be guilty of restraining trade. Notwithstanding the facts, Judge Jackson wrote that the Appellate Court's decision "ignores reality by making it too easy for Microsoft to claim it has the freedom to bundle any software technologies to Windows." Clearly, Judge Jackson has his mind made up and is not interested in what the higher courts think. He has become an advocate.

This loose-canon approach to anti-trust law is very disturbing. By unleashing the entire resources of the federal government against Microsoft, is not this a bureaucrat's form of legalized blackmail? A lesser company would have to go along just to survive. To its credit, Microsoft has not acquiesced.

In order for the Justice Department to have a case, it would have to be in the public's best interest to have more expensive, less user-friendly and far more complex technology. The reason why Linux will lag behind Windows, even if it had Microsoft's Office application, would be because it lacks an easy-to-use interface, an installation system and a development plan. And there is no economic reason why Microsoft would want to create an Office application for Linux because its market is too small to warrant it.

So, the Justice Department's case is not about public policy and the consumer, it is about power and the reach of the federal government. In breaking up Microsoft into two companies, the Justice Department plans on heavily regulating both resulting companies because of "potential" monopolistic practices. The federal government is woefully out of its league in crafting regulatory remedies appropriate to a complicated, fast-changing industry. By pretending it is competent in shaping the course of the technology industry, the federal government is assuming a centralized planning role that has failed European industry and is far inferior to the free enterprise system that has made the

U.S. economy the envy of the world. The Justice Department is about to kill the goose that laid the golden egg.

The federal government can't have it both ways. Integration is the key to standardization, which leads to mass markets for technology and today's vibrant economy. Yet, at the same time, integration is deemed a predatory monopolistic tactic that must be remedied by anti-trust law and federal regulation. The Justice Department wants to see more operating systems which will make systems much more complex to operate, much more expensive and much less productive. This would kill the new economy engine that is tied to productivity increases and lower inflation. The only way in a free enterprise system to assure global leadership in innovation is to make sure it remains free. Judge Jackson and the federal government are over-reaching in trying to gain regulatory authority over the most dynamic growth engine in the world's economy.

The Justice Department's success in getting Judge Jackson to rule that Microsoft is engaged in predatory tactics has resulted in Attorney Generals in 17 states to join the proceeding. To the uninformed public, this would lead one to believe where there is smoke there is fire. Attorney General Eliot Spitzer of New York said, "Microsoft's continuing assertions that they have committed no wrongs suggest that they are incapable of recognizing that their behavior in the past was in part improper, and therefore it suggests that they are incapable of determining right from wrong." Spitzer is suggesting that Microsoft has no presumption of innocence and by disagreeing with allegations, they are therefore inherently evil. This belies all reason. The only way Microsoft can win, based on Spitzer's logic, is to plead guilty. Relative to the proposed break-up, Bill Gates has said, "We think today's proposals are very disturbing, not just for Microsoft but for consumers and the entire high-tech economy. These proposals were not developed by anyone who knows anything about the software business."

The intellectual debate over the government's remedy of breaking up the company and heavily regulating the two successor organizations will focus on the government's case that a break-up will foster innovation. This argument is moot to the extent there is any federal regulation or intervention because it presumes less innovation will occur without government involvement, which is simply not the case. Even if the break-up would foster innovation, that does not necessarily mean it will have a positive impact on the consumer. The government experts will say whatever the government wants them to say, which is consistent with Judge Jackson ignoring Appellate Court rulings and Supreme Court opinions that would be contrary to the Justice Department's objective. Paul Romer of Stanford, Carl Shapiro of UC at Berkeley and Rebecca Henderson of MIT, all leaders in the emerging new mainstream in economics and all in their late 30's to 40's, have studied the effects of innovation and new technology on economic growth, industrial organization and corporate behavior. Romer, son of Roy Romer, former Democratic Party national chairman, wrote, "The Court's decision will profoundly affect the information industry, the most technologically dynamic sector in our economy, by encouraging conditions that encourage increased competition in the operating system market. The proposed Microsoft remedy will increase the rate of innovation in the software industry and thereby increase the rate of growth for the economy as a whole. The lasting stream of benefits that can be expected to follow from this remedy will substantially outweigh any temporary costs that may involve." Thus, it would seem the federal case would risk splitting up Microsoft because, in the long-term, it may increase competition by taking away a hard-won competitive advantage from one firm and giving it to another, thereby accelerating innovation in America's high tech economy which would benefit consumers. In the short term, nothing nearly as elegant or as easy to use as our current Microsoft operating systems which have readily integratable applications will be created. Multiple operating systems would result in skills not being transferable from one job to another. The bugs in programming would become more pronounced, and unbundled, unintegrated systems and applications would result in an immensely more complex and certainly more expensive computer environment, just when the next wave of less computer-literate, less forgiving and more demanding consumers are coming on-line. The energy and momentum that the internet has so deservedly garnered will wane as productivity increases decline in the face of inflationary forces and a deteriorating economy.

THE JUSTICE DEPARTMENT IS INAPPROPRIATELY USING OUR JUDICIAL SYSTEM TO ADVOCATE A SPECIFIC POINT OF VIEW WHEN THE CONSTITUTION STATES THAT JUSTICE MUST BE SO IMPARTIAL AS TO BE BLIND

This is not an academic exercise. We have to deal with the real world and with real people and a real economy in capital markets which are at a particularly fragile state. In the abstract, everything looks good, yet the short and intermediate reality is the only thing we can be sure of. The most disturbing aspect of the government's position is that it has gone far astray of public policy for the public good. The Justice Department is inappropriately using our judicial system to advocate a specific point of view when the Constitution states that justice must be so impartial as to be blind. The use of the judicial system as an advocacy platform is a misuse of the power, resources and trust of the federal government. For the federal government to become an adversary, not based on a point of law but as a matter of opinion, is an abuse of power. There is no case to be made that the free market can be improved upon with government intervention.

Let's assume the worst case. In Microsoft's June 1995 meeting with Netscape, let's suppose Microsoft, in fact, sought to persuade Netscape to stop delivering browser software to the Windows market. Whatever happened in that meeting, the proposal was never accepted, and attempted actions have almost never been viewed by the Supreme Court as being illegal. Let's suppose the Supreme Court found Microsoft guilty of attempted monopolistic tactics, does a death penalty of breaking up the company and forever submitting it to onerous federal regulations serve a public good? Is not the punishment far out of line with the purported crime, attempted but not executed? In fact, given the importance of technology to our economy and given our world dominance in technology, do we really want bureaucrats to have any say or involvement over the success of the free enterprise system today?

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Sixty-nine percent of the public sees through the Justice Department's allegations and supports Microsoft. The most disturbing question of all is how did this get so far? The answer is that Microsoft will never again ignore the expensive but necessary Washington, D.C. lobbying machine which welds massive power and could have effectively nip this in the bud.

Microsoft's integration of many applications in its operating system greatly simplified the use of personal computers and aggressively drove down the cost of technology. In effect, by Microsoft controlling 90% of personal computer operating systems, it created a standard for operating systems that was crucial in creating a mass market for technology. This was the catalyst for our new economy growing at a record pace. Microsoft is the goose that laid the golden egg and has every reason to believe Judge Jackson's decision will be reversed. Whether it is the public, the Appellate court or the Supreme Court, there is great comfort that the facts, the law and the reason are on Microsoft's side. The question is why is this action being taken and what does it tell us about the Justice Department? Does this action build your trust, faith and confidence in the federal government or erode it? Does it say that too much power has been vested in individual judges? Does it mean that every free enterprise is subject to the prospect of federal regulation by any means necessary, whether warranted or not? Does it mean that our economy and free enterprise system is slowly losing its free market status as the U.S. regresses toward the federalized malaise of England and Europe? These are disturbing questions that lends one to the conclusion that as a matter of public policy, the anti-trust laws of old may not be well-suited to today's new economy, depending on whether power or the public's well-being is the respective consideration. If the public good is to be served and if America is to remain preeminent in technology, then free markets should be protected at all cost. ■

J.C. Bradford Merges With PaineWebber And Cites Internet Brokerage Changing Economics Of The Business

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Their entire focus was how to move the company forward. As national sales manager, Powell had nearly doubled the size of the firm in five years by successfully recruiting against the major firms and had every reason to believe the sky was the limit. They had outlined a plan to remain independent and eventually take the partnership public in an initial public offering. One month after Powell assumed the reins at J.C. Bradford, Merrill Lynch & Company announced plans to plunge into the world of on-line trading, offering trades at $29.95. Not only did J.C. Bradford not offer on-line trading but in a matter of days, the dynamics and economics of the business had changed radically. Powell advised Mr. Bradford that if the firm matched Merrill's move it would cut its profits and value by a third. This bad news came on the heels of a hot IPO market, attracting Wall Street's powerhouse investment banking firms to fledgling technology firms in the southeast. Bradford knew those firms and had relationships with their principals, but their banking and technology focus was on the old economy and the more reliable industrial companies it knew so well. As underwriting demand for old industrial companies faltered, the number of Bradford's stock-and-bond offerings dropped from its high of 55 in 1996 to 16 last year. The combined impact of declining commission rates and dwindling investment banking revenues painted a much different picture than the firm was used to seeing. Earnings last year were $41 million on record revenues of $600 million, which compares with profit of $65 million on $475 million in revenue in 1996. Jeff Powell and Jimmy Bradford immediately recognized there was the potential for a significant and on-going earnings squeeze while concurrently the firm needed to make a sizeable investment in technology and increase its capital base to be more competitive in investment banking and corporate underwriting.

Bradford and Powell initially thought that rather than remaining independent and eventually going public as planned, they would instead focus on finding a strategic partner. A firm like Lehman Brothers or Hambrecht & Quist that had a strong capital base, strong banking and syndicate operations but no retail brokerage franchise would be a perfect fit. But just as they began to consider their choices, Chase Manhattan acquired Hambrecht & Quist, and Jimmy Bradford concluded the best option was to sell Bradford outright. He reasoned he could not afford to waste any time pursuing prospective strategic partners as the longer he waited, the less valuable the Bradford franchise would become. With the decision having been made to sell, it was up to Jeff Powell to pick the firm's new partner.

Powell and Jim Graves, his chief operating officer (a former investment banker) and No. 2 in command, whittled a list of 84 potential partners down to 20. Each visited ten and in the ensuing weeks, they huddled constantly, debating the merits of various companies. By mid-January, two-page letters were sent to five interested bidders (a bank, three securities firms and an "out of the box" firm that would not take "no" for an answer) for a formal proposal. In a few weeks, this list of five was whittled to two, PaineWebber and Morgan Stanley Dean Witter. PaineWebber won because it was a better cultural fit. PaineWebber is primarily a brokerage franchise without a massive investment banking business and had spent millions in building its on-line trading platform called "Edge." It has a strong fee-based consulting business and a PMer business which would give J.C. Bradford access to processes which would minimize the impact of declining commission brokerage rates for trade execution. PaineWebber was the right choice for the time and had expressed interest in J.C. Bradford months before Bradford had any interest in selling.

The insight we can glean from J.C. Bradford's experience tells us much about how the industry will unfold. First, the retail and institutional brokerage operations of all firms will be similarly affected by the declining prices for trade execution, so the squeeze in commission brokerage experienced by Bradford will be universal. Within the next 10 years we will have seen the average brokerage trade go from $80 to less than $10. This means that brokers have to work 10 times as hard to generate the same

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