Subcommittee on Innovation, Data, & Commerce
Hearing entitled "Fiscal Year 2024 Federal Trade Commission Budget"
[April 18, 2023]

Documents for the record

At the conclusion of the meeting, the chair asked and was given unanimous consent to include the following documents into the record:

1. A letter from Engine and an attached report entitled, "Privacy Patchwork Problem: Costs, Burdens, and Barriers Encountered by Startups (March 2023)," April 17, 2023, submitted by the Majority.
2. A Bloomberg Law article entitled, "FTC Lawyers Leave at Fastest Rate in Years as Khan Sets New Tone," March 16, 2023, submitted by Representative Bilirakis.
3. A Wall Street Journal article entitled, "A Hostile Takeover of the FDIC," December 15, 2021, submitted by the Majority.
4. A Wall Street Journal opinion column entitled, "Why I'm Resigning as an FTC Commissioner," February 14, 2023, submitted by Representative Dunn.
5. A Wall Street Journal opinion column entitled, "The FTC's Unholy Antitrust Grail," April 3, 2023, submitted by Representative Bilirakis.
6. A letter from Federal Trade Commission Chair Khan to Representatives Cicilline and Buck, September 28, 2021, submitted Representative Allen.
7. A letter from a coalition of businesses and groups to Chair McMorris Rodgers, Ranking Member Pallone, Chair Bilirakis, and Ranking Member Schakowsky, submitted by the Minority.
8. A letter from undersigned Members of Congress to Federal Trade Commission Chair Khan, September 21, 2022, submitted by the Majority.
9. A Federal Trade Commission press release entitled, "Federal Trade Commission, National Labor Relations Board Forge New Partnership to Protect Workers from Anticompetitive, Unfair, and Deceptive Practices," July 19, 2022, submitted by the Majority.
10. A National Labor Relations Board press release entitled, "NLRB Issues Notice of Proposed Rulemaking on Joint-Employer Standard," September 6, 2022, submitted by the Majority.
11. A letter from Alumni of the FTC[3] to the Federal Trade Commission, April 12, 2023, submitted by Representative Cammack.
12. A press release entitled, "FTC, Justice Department, and European Commission Hold Third U.S.-EU Joint Technology Competition Policy Dialogue," March 30, 2023, submitted by Representative Duncan.
13. A letter from Representatives Duncan and Guest to Department of Commerce Secretary Gina Raimondo, and U.S. Trade Representative Katherine C. Tai, March 7, 2023, submitted by Representative Duncan.
14. A Federal Trade Commission blog post entitled, "Keep your AI claims in check," submitted by the Majority.
15. A letter from undersigned Members of Congress to Federal Trade Commission Chair Khan, October 13, 2022, submitted by Representative Joyce.
16. A letter from Neil L. Bradley of the U.S. Chamber of Commerce to Chair Khan and Ranking Member Pallone, April 18, 2023, submitted by the Majority.
17. A letter from Alumni of the FTC[5] to Chair Khan and Commissioners Bedoya, Phillips, Slaughter, and Wilson, September 20, 2022, submitted by Representative Cammack.
18. A report from the Office of Inspector General, Federal Trade Commission, entitled, "Audit of the Federal Trade Commission's Unpaid Consultant and Expert Program," August 1, 2022, submitted by Representative Cammack.

19. A letter from the Center for AI and Digital Policy to the Chairs and Ranking Members of the House Energy and Commerce Committee and the Innovation, Data, and Commerce Subcommittee, April 18, 2023, submitted by the Majority.
20. A complaint filed with the Federal Trade Commission concerning consumer protection and artificial intelligence, submitted by the Majority.
21. An associate letter to the complaint filed with the Federal Trade Commission concerning consumer protection and artificial intelligence, April 3, 2023, submitted by the Majority.
22. An opinion letter in the New York Times entitled, "Regulating A.I.: The U.S. Needs to Act," submitted by the Majority.
23. A letter from Senator Kevin Cramer to Mr. Kenichiro Yoshida, April 13, 2023, submitted by Representative Armstrong.

April 17, 2023

Committee on Energy and Commerce
Subcommittee on Innovation, Data, and Commerce
2125 Rayburn House Office Building
Washington, D.C. 20515

VIA EMAIL

Re: Hearing titled "Fiscal Year 2024 Federal Trade Commission Budget."

Honorable Members of the Subcommittee on Innovation, Data, and Commerce:

Engine is a non-profit technology policy, research, and advocacy organization that bridges the gap between policymakers and startups. Engine works with government and a community of thousands of high-technology, growth-oriented startups across the nation to support the development of technology entrepreneurship. The Federal Trade Commission impacts several issues important to startups and technology entrepreneurship, including, e.g., data privacy and competition and we accordingly appreciate the subcommittee holding a hearing to review the agency.

The FTC needs direction from Congress on data privacy. In Fall 2022, the FTC issued an advanced notice of proposed rulemaking on "commercial surveillance." From the title to the framing of the questions, the ANPR started on a skewed foundation rather than representing a nuanced inquiry from which to build a balanced solution. As we told the Commission, startups need clarity and consistency from a federal privacy framework, and an overly burdensome privacy framework will make it more difficult for startups to compete against large and incumbent companies.[1] Startups are already experiencing significant burdens as they navigate the growing patchwork of state privacy laws—with some experiencing costs of $300,000 or more and an additional $60,000 for each state added to the patchwork.[2]

On privacy, there is a clear role for the FTC to play in enforcing the law and protecting consumers, but pursuing its own privacy rules would be counterproductive for startups and consumers, and merely add another layer to the patchwork of privacy rules. Instead, Congress should pass a uniform, comprehensive privacy law to create certainty and clarity, and the FTC should have a role in consistently enforcing that law.

---

[1] *Comments of Engine Advocacy in response to Commercial Surveillance ANPR, R111004*, Engine (Nov. 21, 2022), https://engine.is/s/Engine-FTC-Privacy-ANPRMComments.pdf.
[2] *Privacy Patchwork Problem: Costs, Burdens, and Barriers Encountered by Startups*, 4 Engine (Mar. 2023), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/6414a45f5001941e519492ff/1679074400513/Privacy+Patchwork+Problem+Report.pdf.

The FTC should facilitate real opportunities for public input. Under the leadership of Chair Khan, the Commission has emphasized transparency and opportunity for public input. But these commitments have often been fraught. The agency prohibited public staff engagements for nearly a year[3] and has fought requests to share public records.[4] FTC open meetings include dedicated time for public input, which thankfully has been allocated to the beginning of most recent meetings, but during meetings with critical business for startups, like around M&A for example, this input opportunity came after Commissioners had already voted.[5] Likewise, at pre-planned agency "listening sessions," chosen speakers that the agency coordinates with ahead of time speak for the majority of time, while others queue for the chance to speak for one-, sometimes two-minute timeslots. No matter how important the issue, startup founders do not have hours to wait in a queue for the possibility they may get to speak for one minute.

The FTC must avoid unintended consequences that harm startups. The FTC works on several key issues important to startups, including data privacy and merger enforcement, and missteps on either of those issues could be very costly for startups. The FTC's increased skepticism toward legitimate M&A activity is alarming for startups because the overwhelming majority of successful startup exits are via acquisition—and in many places outside of major startup hubs like Silicon Valley and New York, acquisition is the only available successful exit.[6] These acquisitions promote the flow of capital and talent in the startup ecosystem and lead to investment in new startups. The FTC's actions in these areas will make it harder for startups to experience a successful exit, something startup founders have asked policymakers to avoid making more difficult.[7] And as highlighted above, unique FTC rules for privacy would add another costly layer for startups and not solve the patchwork problem.

We hope the subcommittee takes into account the experiences of startups as it reviews the FTC. To that end, we've attached resources on data privacy and startups, and acquisitions and startups.

---

[3] *See, e.g.*, Leah Nylen and Betsy Woodruff Swan, FTC staffers told to back out of public appearances (July 6, 2021), https://www.politico.com/news/2021/07/06/ftc-staffers-public-appearances-498386; Josh Cisco, *To Combat Declining Staff Morale, FTC Chair Khan Lifts Public Speaking Ban as Deputy Issues Apology*, The Information (May 26, 2022), https://www.theinformation.com/articles/to-combat-declining-staff-morale-ftc-chair-khan-lifts-public-speaking-ban-as-deputy-issues-apology.

[4] *See e.g.*, Jan Wolfe, *U.S. Chamber of Commerce Sues FTC, Saying Agency Operates in Secret*, Wall Street Journal (July 14, 2022), https://www.wsj.com/articles/u-s-chamber-of-commerce-sues-ftc-saying-agency-operates-in-secret-11657811414.

[5] *See e.g.*, Open Commission Meeting - July 21, https://www.ftc.gov/news-events/events/2021/07/open-commission-meeting-july-21-2021; Open Commission Meeting - September 15, https://www.ftc.gov/news-events/events/2021/09/open-commission-meeting-september-15-2021.

[6] *Exits, Investment, and the Startup Experience: the role of acquisitions in the startup ecosystem*, Engine (Oct. 2022), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/6356f5ccf33a6d5962bc7fd8/1666643406527/Exits_Investment_Startup_Experience_role_of_acquisitions_Report_Engine_Startup_Genome.pdf.

[7] *Id.* (especially startup founders discussing their acquisition experiences, including, e.g.: "The acquisition of 21 by Perforce was a success and the right move for us, and I hope policymakers don't make these sorts of transactions more difficult." ~ Shani Shoham, CEO, 21 Labs (acquired by Perforce); "Being acquired is a desirable startup exit path, and restricting it will lead to less capital and less startup competition." ~ Steven Cox, Founder & CEO, TakeLessons (acquired by Microsoft)).

Engine is committed to being a resource for the subcommittee on these and other issues impacting technology entrepreneurship.

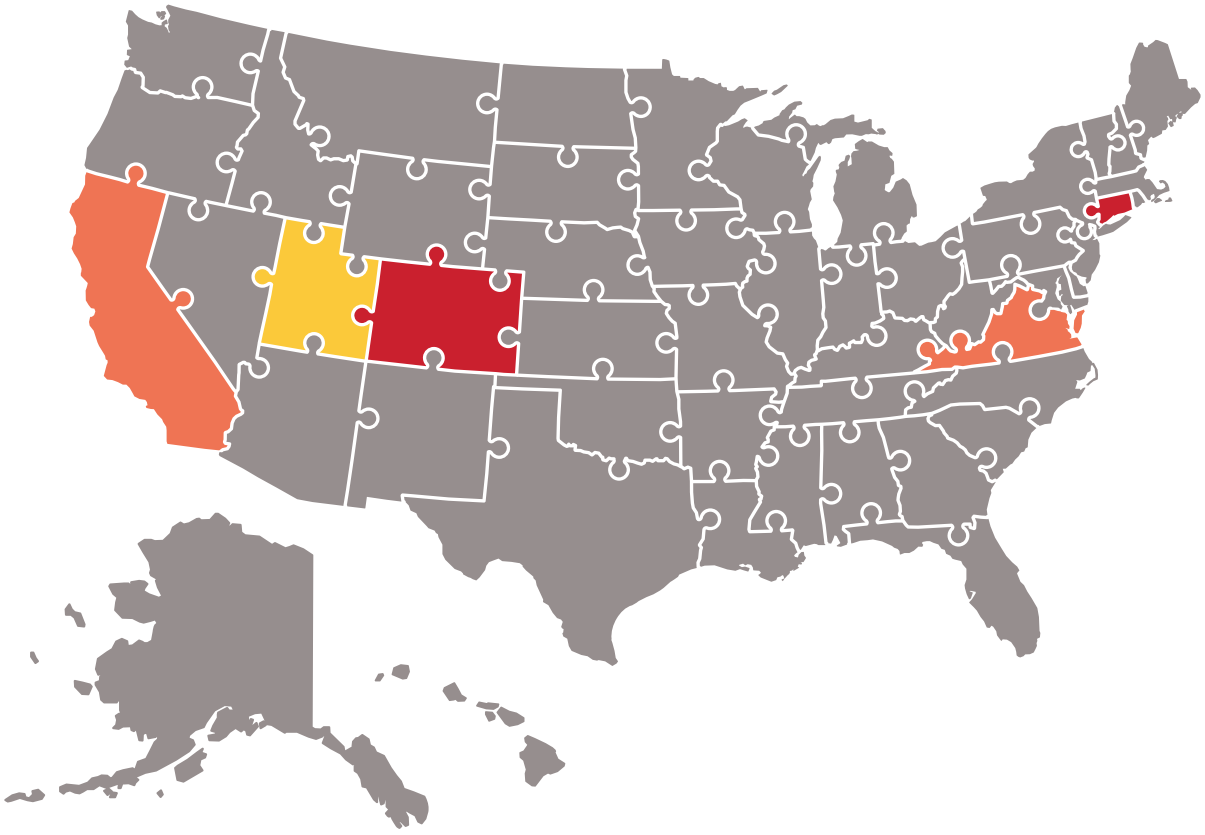
Sincerely,

Engine
700 Penn Ave SE
Washington D.C. 20003

Engine

Privacy Patchwork Problem:

Costs, Burdens, and Barriers Encountered by Startups



March 2023

ABOUT ENGINE

Engine was created in 2011 by a collection of startup CEOs, early-stage venture investors, and technology policy experts who believe that innovation and entrepreneurship are driven by small startups, competing in open, competitive markets where they can challenge dominant incumbents. We believe that entrepreneurship and innovation have stood at the core of what helps build great societies and economies, and such entrepreneurship and invention has historically been driven by small startups. Working with our ever-growing network of entrepreneurs, startups, venture capitalists, technologists, and technology policy experts across the United States, Engine ensures that the voice of the startup community is heard by policymakers at all levels of government. When startups speak, policymakers listen.

Engine is grateful for the research assistance and contributions of Annie Eng and the University of Michigan Ford School of Public Policy Program in Practical Policy Engagement to this report.

CONTENTS

Startups need a federal privacy framework that works for them

Startups need a federal privacy framework that creates uniformity, promotes clarity, limits bad-faith litigation, accounts for the resources of startups, and recognizes the interconnectedness of the startup ecosystem.

Startups care about the privacy of their users and invest heavily in data privacy and security.

$100,000 – $300,000+

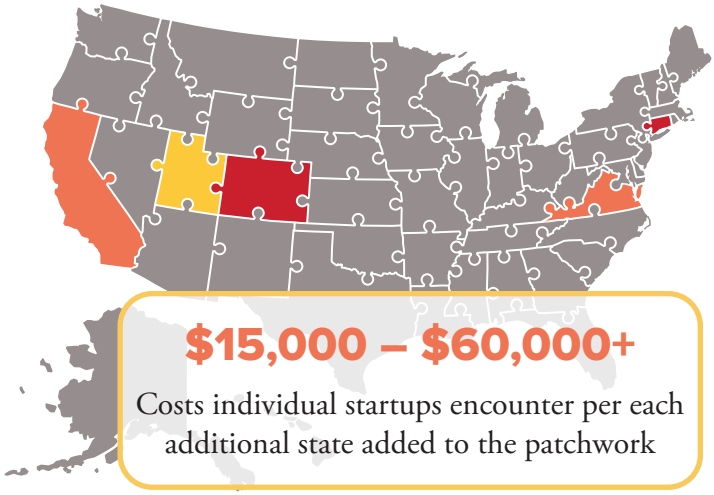
Amount individual startups invest in their data privacy infrastructure and compliance with current or soon effective privacy laws

"We care a great deal about privacy and we want to be compliant, but it can be very expensive and complex."

Ben Brooks, Founder & CEO, PILOT, New York, NY

"Working with children, our priority is protecting their data."

Katherine Grill, Co-Founder & CEO, Neolth, Walnut Creek, CA



$15,000 – $60,000+

Costs individual startups encounter per each additional state added to the patchwork

A patchwork of privacy laws creates confusion and duplicative costs for startups.

Five states have passed and enacted comprehensive data privacy legislation and already this year more than a dozen states have introduced at least three dozen privacy laws. The rapidly shifting landscape of state privacy laws makes compliance difficult for startups and leads them to spend considerable time and resources navigating these disparate, complex frameworks.

"The rules can vary significantly on a state-by-state level. On top of that, our attorneys keep telling us that they're still changing fast, which means it's hard to have a stable, up-to-date privacy policy you feel confident is fully compliant."

Camila Lopez, Co-Founder, People Clerk, Miami, FL

"In the U.S., many states have their own rules—or no rules—and we have to approach compliance in every state on a case-by-case basis...trying to figure out how to build a business in an environment with differing rules about the same issue becomes hard and expensive."

Aditya Vishwanath, Co-Founder & CEO, Inspirit VR, Palo Alto, CA

$55,000

Average monthly resources of a venture-backed, seed-stage startup

"As a high-growth and early-stage startup trying to grow fast, you're at a major competitive disadvantage...I would have to raise an entire second Series A to navigate many of these frameworks."

Sam Caucci, Founder & CEO, 1Huddle, Newark, NJ

Startups need Congress to act.

"It would be helpful to have a nationwide standard when it comes to data privacy policy, especially since we're looking to expand into new states."

Andrew Prystai, CEO & Co-Founder, EventVesta, Omaha, NE

"One uniform, consistently enforced federal policy framework could help make running RAVN easier."

Tani Chambers, Co-Founder & CEO, RAVN, New York, NY

Engine

INTRODUCTION

Data privacy has been top of mind for consumers, policymakers, regulators, companies, and entrepreneurs for the past several years, in the wake of broad privacy rules in the EU, and action in several U.S. states. The U.S., which has long had a sectoral approach to privacy, remains without a comprehensive privacy framework, and many states have reacted by proposing, passing, and implementing their own varying—and potentially conflicting—comprehensive privacy laws. The Internet does not stop at state borders, and as more and more states pass unique privacy laws, the volume of rules for startups to keep up with is growing, threatening to bury resource-strapped startups under duplicative compliance costs, limit their scalability, and burden their chances of success. This report seeks to enumerate those impacts of the growing patchwork of privacy laws upon the startup ecosystem.

Startups should be a key consideration as policymakers advance privacy rules. They have to navigate the same legal and regulatory framework without the resources of their larger counterparts—but much of the conversation focuses on the practices of large Internet companies. To adequately include startups' experiences in data privacy debates, policymakers need a window into startups' responses to privacy laws, the resources they devote toward compliance, and an understanding of costs—direct and indirect—imposed on startups. This report can provide these insights for policymakers in statehouses and Congress alike.

The findings of this report could not be more clear: the U.S. needs a consistently-enforced, uniform federal privacy framework to create privacy protections for all Americans and certainty for the startups that serve them. Startups vehemently endeavor to comply with the rules that apply to them, but an inconsistent state-by-state patchwork is unworkable and unnecessarily saps limited resources that startups need for activities essential to their growth and survival. Congress has faced calls for many years from many corners—from privacy advocates to the startup community—to create a federal privacy law. Last Congress saw momentum toward a federal privacy law, and that work looks poised to continue this Congress. The findings of this report, coupled with an explosion of privacy law-related activity in statehouses across the country should add to that momentum.

METHODOLOGY

To unpack the impacts of disparate state privacy laws, this report has three main components: an overview of the current state privacy patchwork, a breakdown of the compliance costs associated with those laws, and startups discussing the impact of the data privacy policy landscape in their own words.

To understand how startups are approaching compliance with the varying, growing, and likely to keep growing number of state privacy laws, we spoke with over a dozen startups, entrepreneur support organization leaders, outside legal counsel to startups, and data privacy and security consultants that work with startups. The conversations took place between October 2022 and February 2023. The startups quoted throughout the report are not necessarily the same startups that contributed cost figures to the findings section of this report. The startups we spoke with were less than two-years-old to over 14, with some having raised no outside investment and others having raised millions of dollars in venture capital. The startup counsel we spoke with worked with both early-stage and growth stage startups, from both top law firms and bespoke firms tailored to startups, located in top startup hubs and smaller startup ecosystems.

To help quantify the costs and other impacts of the state privacy patchwork, this report breaks down compliance costs into several component parts: legal, audit, and advisory costs; technology costs; business and operations costs; and opportunity costs. The activities and expenses associated with each of those categories are discussed in further detail where they appear. Startups offered both actual costs—those they had already incurred, contracted for, or committed to—and expected costs—those they had budgeted, sought estimates for, or otherwise knew to expect based on previous experiences. Segmenting costs in this way offers insight into the different types of impacts on startups, and delivers a concrete, startup-level view of compliance with disparate state privacy laws—offering a tangible addition to macro-level estimates of costs of the state privacy patchwork problem.

LEGISLATIVE LANDSCAPE

At the federal level, there are several sectoral privacy frameworks that cover, e.g., health, financial, or education data. The Children's Online Privacy Protection Act imposes specific requirements for Internet services directed toward those under age 13. There is no federal data privacy statute that governs data and personal information in a comprehensive way. In this absence, several states have proposed and passed legislation to provide this governance for their citizens. While the goals of each state law are similar, and purport to do similar things, they are not the same. This section briefly explores this landscape.

The privacy patchwork

Five states—California,[1] Virginia,[2] Colorado,[3] Connecticut,[4] and Utah[5] —have passed and enacted comprehensive data privacy legislation. Within the first few weeks of the 2023 state legislative calendar, more than a dozen states have introduced at least three dozen privacy laws, which have seen varying levels of movement toward passage. Each of the enacted laws are in effect or will take effect later this year, and startups are parsing and preparing for what that means for them. These activities and their costs are explored in the findings section.

Varying definitions

Even if they are oftentimes inspired by one another, the state laws are not the same, which is why the privacy landscape is often referred to as a "patchwork." This creates complexity and makes parsing the obligations for startups difficult. For example, the enacted state laws define sensitive personal information differently—from which certain consumer rights and obligations arise. The states consider many of the same types of information sensitive—e.g., race, ethnicity,

mental or physical health or diagnoses, sexual orientation, religious beliefs, citizenship status, genetic or biometric information—but have notable differences. Geolocation data is considered sensitive in most states but not Colorado. But that data becomes sensitive if used to infer other sensitive information like religion or health status through e.g., visits to a church or healthcare provider. And California considers additional information to be sensitive, like contents of email, financial data, or certain government ID information.

Consumer rights

The laws grant many of the same consumer rights, but not all of them. Rights to access, delete, port, and opt-out of sale are included in each state (but the application of those rights might vary). Most states also have rights to correct information but not Utah. The timeframe companies have to respond to requests is a relatively consistent 45 days across most states (and include the possibility of extensions), but some states require acknowledging and responding to certain requests on much shorter timelines. Facilitating these consumer rights is likely to take time and resources for startups, given they may not presently have the infrastructure in place to handle such requests or ensure that bad actors do not exploit the rights to gain access to customer information. Compounding these potential burdens, what constitutes a "sale" varies among the states, and California introduces the right to opt-out of sharing—which is a new concept.

Opt-in or opt-out?

The laws have different opt-in thresholds, some of which hinge on sensitive information definitions (that again, also vary). For example, in Virginia, Colorado, and Connecticut, consumer opt-in is required to process sensitive information. In Utah, consumers can opt-out, and California consumers can limit use of such information.

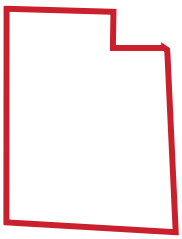
For startups, other noteworthy consumer opt-out rights found in the state laws include rights to opt-out of targeted advertising and rights to opt-out profiling or automated decisionmaking. Many startups leverage targeted advertising to reach new users and while others may generate revenue by selling ad space. Likewise, many startups have automated processes integrated into their products or, for some, it might even be their core service. Several states' laws contemplate such an opt-out right, while Utah's does not. And still others, like California, leave similar key questions to regulators.

Impact assessments

Most of the state laws require companies to conduct data impact assessments. At present, several startups are likely to be unfamiliar with the concept, which comes from the EU privacy rules, while larger startups and tech companies are more likely to be familiar. For smaller startups, preparing and submitting multiple, different assessments to the various states could create new costs.

Scope and enforcement

As outlined below, who the laws apply to vary by state, but several have adopted similar thresholds. For startups, the many disparities found in the laws have a lot of practical impacts and lead to increased compliance costs, confusion and uncertainty. Thankfully for startups, most of these laws allow companies to cure within a certain time period unintentional violations they are notified about. And most laws are enforced by the government or otherwise limit private rights of action.

State	Effective Date	Applicability thresholds	Right to cure violations, Cure period	Private Right of Action
California 	CCPA: Jan 1 2020 CPRA: Jan 1, 2023	Does business in CA and has $25 million+ in revenue or "buys, sells, or shares" personal information of 100,000+, or derives 50%+ of revenue from selling or sharing personal information, or certifies compliance to regulator regardless of above	Yes, at enforcers' discretion or 30 days for data breaches	Yes, limited
Virginia 	Jan 1, 2023	Conducts business in VA or produces products or services targeted to VA residents and "controls or processes" personal data of 100,000+, or 25,000+ and derives 50%+ of revenue from "sale of personal data"	Yes, 30 days	No
Colorado 	July 1, 2023	Conducts business in CO or delivers products or services intentionally targeted to CO residents and "controls or processes" personal data of 100,000+, or 25,000+ and derives revenue or receives discounted goods or services from "sale of personal data"	Expires Jan 1, 2025, 60 days	No
Connecticut 	July 1, 2023	Conducts business in CT or produces products or services targeted to CT residents and "controls or processes" personal data of 100,000+, or 25,000+ and derives 25%+ of revenue from "sale of personal data"	Yes, 30 days	No
Utah 	Dec 31, 2023	Conducts business in UT or produces products or services targeted to UT residents, has 25 million+ in revenue and "controls or processes" personal data of 100,000+, or 25,000+ and derives 50%+ of revenue from "sale of personal data"	Expires Dec 31, 2024, 60 days	No

FINDINGS

Startups we spoke with view data privacy and security as a business prerogative, and invest heavily—especially as a percentage of the few resources they have on hand—in doing right by their users, customers and clients. The careful thought given to data privacy by startup leaders is heartening but also underscores deep trade-offs they face when navigating the privacy landscape. The findings of this report reveal that complying with a growing patchwork of unique state privacy laws is an expensive, difficult task that must be solved with one uniform, consistently enforced federal privacy framework to support startup growth and ensure data privacy protections nationwide.

All of the startups we spoke with viewed securing user data and respecting the privacy of their users as priorities, but, despite taking significant steps to those ends, they often expressed confusion and uncertainty about their obligations under the law. Startups in industries falling within existing sectoral federal privacy regulations, like health, education, or finance, knew what they must do to be compliant with those rules, but they were not as confident in their ability to keep up with new and evolving state privacy rules.

> *"Working with children, our priority is protecting their data [...] we worked with our counsel at Latham and Watkins to create our terms of service and work with our school customers on any state-specific addendums. Having various laws makes this process a little harder, so it would definitely be nice if there was just one standardized privacy law."*[6]
>
> **- Katherine Grill, Co-Founder & CEO, Neolth, Walnut Creek, California**
>
> *Neolth leverages technology to equip students and schools with mental health resources.*

All startups we spoke with lamented the evolving patchwork of state privacy laws as confusing, hard to keep up with, costly, and burdensome. In some cases, startups avoided intentionally seeking to serve users or businesses in states with unique data privacy laws because they could not afford to evaluate if their current data privacy and security practices were sufficient for compliance. The reflex is similar to that of many startups following the European Union's General Data Protection Regulation—who used geoblocking technologies to avoid EU users.[7] Similar technologies to block traffic from various intra-country jurisdictions like states do not really exist. Instead, startups avoid advertising to users or forgo otherwise lucrative business contracts in certain states in the hopes of staying below the applicability thresholds of those states' data privacy laws.

> *"...a significant challenge for us has been data privacy. It would be helpful to have a nationwide standard when it comes to data privacy policy, especially since we're looking to expand into new states. Part of the reason that we have not expanded into certain states like California is because of the resources required to handle California Consumer Privacy Act (CCPA) compliance, which is something that we have to think about every time we look at entering a state that has its own, unique privacy compliance requirements."*[8]
>
> **- Andrew Prystai, CEO & Co-Founder, Event Vesta, Omaha, Nebraska**
>
> *Event Vesta is an event discovery and promotion platform that improves connectivity between event organizers and attendees.*

Similarly, attorneys and advisors find the quickly-changing legal landscape around privacy tough to keep up with. Several described the amount of time they had to spend researching and keeping up to date on the latest developments in state data privacy regulations, noting that it went far beyond anything they could reasonably bill a client for. As one attorney for early-stage startups added, "if it takes us that long with all these changes, I can't understand how [policymakers] expect a startup founder to know what to do."

Compliance costs

$100,000 – $300,000+
Compliance costs

$15,000 – $60,000+
Additional per-state costs

Startups took disparate approaches to compliance with varying data privacy and security regimes they are or might be subject to, but all shared common themes. Many compliance-associated activities could be done once because they are found in several laws—like reconfiguring data storage to create the ability to delete user data—while other activities needed to be done for each new law—like audits, impact assessments or evaluating and updating privacy policies. This report reflects these realities by reporting both one-time costs, and marginal, per-state costs of privacy law compliance faced by most startups. (A minority of startups—usually those later-stage or in regulated industries—reported spending more, sometimes much more, than these figures.)

To help break down the cost of compliance and lay out the types of compliance activities startups undertake, we separate them into component parts for discussion.

Legal, audit, and advisory costs

For a startup, legal, audit, and advisory costs associated with privacy law compliance primarily includes the cost to hire legal talent, retain outside counsel, engage privacy consultants, or commission auditors. Startups secure these services to understand obligations under varying data privacy laws; update their privacy policies and internal controls; verify legal compliance; or attain certifications like SOC 2. Outside of the associated pecuniary costs, these activities are time-consuming and potentially distracting for startup leadership teams, with startups reporting it taking from as little as two months to as long as two years to complete such activities.

Perhaps the most basic and outward-facing compliance task for a startup is creating and updating their privacy policy. To create or update a privacy policy, startup attorneys said they typically charge around $1,500 for very basic policies to around $6,000 for more tailored policies. Attorneys in smaller markets charged around $400 an hour for additional work, while attorneys in startup hubs or at larger firms billed at $1,000 or more an hour. These figures were confirmed by startups with legal bills for privacy policies and related activities ranging up to $15,000.

In parallel to legal counsel, many startups sought advisory services—perhaps also from an attorney, but usually from a privacy consultant or auditor—to evaluate their business, understand their obligations under the law, and perform risk assessments. Most startups reported these costs ranging between $20,000 and $50,000. In response to the recommendations of an advisor, startups usually found they may need to implement legal, technical, or business-model changes, adding additional expense on top of those costs. And while companies do not start from scratch with each new state or jurisdiction where the company encounters a new privacy law, it is still costly to (re)evaluate obligations and implement changes. For new, additional states, some startups reported identical advisory costs, while others said slightly less on a marginal basis, estimating it will cost them $10,000 per each additional state just to start reviewing and modifying policies for compliance. Finally, rather than a fee-for-service arrangement associated with a particular set of compliance activities, some startups had privacy consultants on retainer to be responsive to their needs—with those startups reporting this cost them $6,000 to $10,000 per month (up to $120,000 per year).

Of course, these ranges can vary significantly based on the startup and their industry subsector as well. One startup in a regulated industry estimated they had spent $5 million on legal and advisory services over the life of the company through developing and updating privacy policies for various state and federal regulatory regimes, performing quality controls and risk assessments, and regularly engaging with auditors and regulators.

Technology costs

As part of complying with new privacy laws, startups often must make changes to their existing systems, develop new technology, or acquire and integrate third-party software products. Generally, decisions to re-design, build, or integrate new technology are products of consultations or audits discussed above, meaning startups may have already spent tens of thousands of dollars before getting to the brass tacks of putting those recommendations into practice.

Many startups reported using third-party software solutions to help automate and manage compliance. These startups reported costs just for the software to be $8,000 to $20,000 per year, which must be integrated into their processes and managed by their staff.

And many startups dispatched their own engineers to redevelop systems where needed. Engineers are some of the most important hires startups make, and some founders report paying themselves minimum wage so that they effectively stretch their resources and pay competitive salaries to their engineers, which tend to range from about $75,000 all the way up to more than $300,000 annually. The average software engineer pay in smaller ecosystems is around $40 per hour, $75 per hour in top ecosystems, and could reach up to $150 an hour for more senior engineering talent.[9] One startup emphasized using at least four engineers to redevelop a system, while another estimated it took 1,000 engineering hours to complete an overhaul for compliance.

Software engineers are critical to developing, building, and growing startups, and how they spend their time is intimately tied with a startups' success and ability to make and market new products. Given the resource constraints of many startups, they may not have six months of engineering time to feasibly steer away from activities central to their existence. And insofar as additional state laws added to the privacy patchwork require engineers' time, they will have a direct impact on startups' core activities.

Business and operations costs

Complying with various state privacy laws implicates business and operational costs, for example around hiring, training, relationships with vendors, business practices, customer acquisition, and sales cycles.

Many startups described needing to reevaluate existing relationships and update contracts with vendors as a result of changes to privacy rules. Often this didn't carry a significant separate monetary cost unless legal counsel needed to be consulted for review. Instead the main cost startups described involved time to evaluate the contracts and implement technical or business changes to be in line with the updated terms.

Most startups emphasized that it takes time and costs money to train their employees with regard to data privacy and security. Some startups approached hiring differently as a result of the evolving legal landscape around data privacy, consciously seeking more senior software engineers and staff with deeper knowledge of privacy rules—and therefore paying higher salaries than otherwise. And these startups noted the pool of talent that is up-to-date on privacy rules is relatively small. With the privacy landscape in flux, it is likely to shrink smaller still.

Startups need to reach potential customers and evaluate their services, and many highlighted impacts or feared impacts of data privacy legislation on those critical business needs. Many startups said they use digital advertising and other marketing tools to find new customers and recognized that privacy laws may impact the effectiveness of those channels in the future. And startups use analytics to evaluate how well their service is performing and to pinpoint areas in need of improvement. Startups reported seeing privacy measures interfering with those basic business insights despite their belief that these insights don't come at the cost of user privacy because they needn't extend to the level of an identifiable individual user.

Other business costs included the additional barriers at the point of sale for startups entering into contracts with clients. This was true for all startups working with enterprise clients, but especially acute for those selling to large entities. For example, an enterprise software startup looking to contract with a Fortune 500 company must work with that company's legal department and certify their compliance with relevant privacy laws. Startups lamented the amount of time these sorts of reviews took—from two to six months, sometimes longer. This strikes at the very vitality of startups since many measure their runway (the amount of time until they run out of capital) in months, not years. In addition to the time that these processes take, they can be very costly, amounting to 10 percent to 15 percent of the value of the contract. Another startup in a more regulated industry emphasized that compliance costs amounted to 20 percent of their contract value.

These costs have impacts on startup competitiveness. Startups spend much more on compliance as a percentage of revenue than their larger competitors,[10] putting them at a resource disadvantage. These tens of thousands missed on a per-contract basis could go toward hiring, R&D, customer acquisition, and other activities to scale their startup. As another consequence of the many varying privacy laws, as large enterprises look to reduce their risk profile, they are looking to contract with fewer vendors, benefiting already large players while startups lose out.

Opportunity costs

All startups and advisors we spoke with unanimously agreed that the opportunity cost of expending effort and resources to meet compliance for multiple states was tremendous, underscoring that there were more productive, value-creating tasks that could be focused on with the time, capital, and other resources spent on compliance without sacrificing meaningful privacy protections for users. Several startups highlighted hiring more full-time employees, conducting research and development, and growing their sales teams to scale the business. And one startup attorney said there were "a hundred other things" that startups would rather do than have to pay their lawyer. Critically, many startups pointed out that these costs could be mitigated if there were one federal privacy framework instead of a shifting landscape to keep up with.

Several founders additionally highlighted major opportunity costs related to fundraising. Founders spend a significant amount of time fundraising, which is needed fuel to support their startups. Startups leaders said time spent on compliance could take away from that, but more pressing is that investors want to see their capital put toward growth rather than legal or other duplicative compliance costs.

STARTUPS AND A FEDERAL PRIVACY FRAMEWORK

Startups need a uniform, consistently-enforced federal privacy framework. Every startup and advisor we spoke with as a part of this project highlighted a federal framework as a solution to the problems they and their startup clients face. In 2022, Congress came closer than ever to passing a comprehensive federal privacy law, but it got hung up on many familiar sticking points. The findings of this report lend insight to startup perspectives on these pressing issues in today's privacy debates, which are discussed in this section.

Startups need clear, bright-line rules

Obligations in any federal privacy framework must create clarity to ensure startups know what they must do to comply. Provisions that e.g., require companies to evaluate on a case-by-case basis or infer the age of their users are the opposite of bright-line rules, and would create additional uncertainty and burdens for startups. In addition, such provisions, which may require companies to collect additional data for analysis and inference, abridge most startups' aversion to collecting and storing data they do not need because of the associated storage costs and heightened risk of breach.

> *"ChessUp came from the idea of making the learning experience of chess much more accessible and immediate, allowing kids to play a game right out of the gate...with their family and not have to worry about the skill differences."*[11] *... "Our experience is built around making chess easier and more approachable to learn. We want the experience to connect to our product to be brief and convenient as well. As a company, we don't want to be in the position of having to collect and retain information about our users' ages or implement age restrictions. That would create a burden for us and be privacy-invasive for our users."*[12]
>
> **- Jeff Wigh, Founder & CEO, Bryght Labs, Overland Park, Kansas**
>
> *Bryght Labs is a connected gaming startup dedicated to making STEM-based games more accessible and the maker of ChessUp.*

Startups need preemption of state laws

Most of the problems and costs encountered by startups are borne of the patchwork of state privacy laws—the variation and the uncertainty of future changes. Preempting state laws and creating a uniform federal framework will remove variation, create certainty, and alleviate tens of thousands in what startups felt were duplicative, unnecessary costs. If a federal framework does not preempt state privacy laws, then none of these benefits will accrue. It would instead merely create more variation by adding another layer to the existing patchwork, and not create any additional certainty as states could still implement unique or even conflicting privacy rules.

> *"We haven't had any issues with putting all necessary safeguards in place to protect our clients' information, but it is difficult navigating compliance with the different privacy laws out there. Currently, the rules can vary significantly on a state-by-state level. On top of that, our attorneys keep telling us that they're still changing fast, which means it's hard to have a stable, up-to-date privacy policy you feel confident is fully compliant. It's pretty frustrating."*[13]
>
> **- Camila Lopez, Co-Founder, People Clerk, Miami, Florida**
>
> *People Clerk is a legal technology platform that provides users with guidance through small claims court procedures.*

Startups are put at risk by private lawsuits

Startups encounter abusive rent-seeking litigation in many areas of the law, especially those with high defense costs and high potential damages.[14] Creating a private right of action in a federal privacy law would empower individuals to sue companies for alleged violations of the law. A private right of action would lead to uneven enforcement and additionally enable bad actors to exploit the high cost of privacy litigation to extract settlements from startups using meritless suits.[15] Instead, a federal privacy law must be consistently and exclusively enforced by expert agencies.

Startups have few resources and have many reasons to avoid long litigations—and bad actors know it and use it to their advantage. Startups can't afford the potentially millions of dollars in legal fees to litigate a case through and are better off paying the plaintiff to go away even if the startup knows they would otherwise win. And even if they did see the case through to defeat the plaintiff's claims—each party pays their own legal costs, making protracted litigation a lose-lose prospect. What's more, protracted litigation is distracting for startup leadership, and it is nearly impossible for startups involved in active litigation to pass diligence needed to raise capital or experience a successful exit.[16]

A federal privacy law must recognize the tools startups use to reach customers

Startups utilize dozens of services to find, engage, and communicate with their current and potential customers—from digital advertising infrastructure to social media to email to chat widgets and beyond. Some startups also sell advertising space on their sites to generate revenue, enabling startups to offer their services to their users for free. If policy frameworks draw stark divides between first and third parties, startups—and other new services—that are just launching and growing a user base, will be inherently at a disadvantage. And startups use tools to evaluate the effectiveness of those ads and the performance of their services. Recent research shows the volume of tools used for these functions and demonstrates their importance to startups.[17]

In addition to obligations for startups directly under data privacy laws, the key services they rely upon to reach customers and generate revenue are also impacted by those laws as well (usually under the higher-threshold, greater obligations parts of the law). As a result, startups experience increased costs and decreased quality of the tools they need. In formulating a federal privacy framework, policymakers must keep the impacts for startups in mind—including impacts felt through the tools they use.

> *"[Some]thing that is important for us to grow our company is the availability of user analytics, which helps us know how our product is performing and how to better serve our users. Measures designed to promote user privacy can pose challenges for basic business insights, like usage and retention. … a more nuanced approach to data collection … would allow us to better serve our customers while respecting their privacy preferences."*[18]
>
> **- Mandy Poston, Founder & CEO, Availyst, Philadelphia, Pennsylvania**
>
> *Availyst is a delivery platform for local grocery, takeout, convenience, and spirit options.*

A federal privacy law must account for the resources startups have on hand

Startups have limited resources. Most startups do not initially raise outside funding, instead rely on personal savings or bootstrapping—using revenue generated by the business. Even the average two-year-old startup that has started to attract outside investment is working with around $55,000 per month in resources, money meant to last for 18 months to two years.[19] Looking at the compliance costs startups are facing in the current privacy landscape, it's easy to see how the state privacy patchwork literally takes months off of the life of a startup.

> *"We care a great deal about privacy and we want to be compliant, but it can be very expensive and complex. ... Various states also have their own privacy laws. Harmonizing those laws nationally would make it much easier for business owners like me and those we work with. ... There's also very little guidance on how to set things up initially and how to have good security and privacy without the costly certifications. These are all issues that have hindered our business. Privacy law is built around sophisticated multinational large businesses, so as a startup we have to learn how to work within a system that isn't made for us."*[20]
>
> **- Ben Brooks, Founder & CEO, PILOT, New York, New York**
>
> *PILOT provides tech-driven virtual group coaching programs to companies that are easy to implement, affordable, and get good results.*

A federal law must also be careful not to impose obligations upon startups that they cannot afford to implement. Compliance thresholds—especially for the most burdensome or costly obligations—must be set sufficiently high to avoid scoping-in startups.

> *"...one uniform, consistently enforced federal policy framework could help make running RAVN easier, especially as a fintech startup. Compliance can be very costly and is one of the reasons we've delayed our technical product. However, if an overarching framework is developed, it would need to consider small businesses and startups and preferably segment the requirements accordingly. Creating a framework built around regulating large companies and big tech could be harmful to smaller companies and startups like RAVN."*[21]
>
> **- Tani Chambers, Founder & CEO, RAVN, New York, New York**
>
> *Ravn is a wealth-building platform tailored to Black women.*

ENDNOTES

1 Cal. Civ. Code § 1798 (2018) https://leginfo.legislature.ca.gov/faces/codes_displayText.xhtml?division=3.&part=4.&lawCode=CIV&title=1.81.5; *see related FINAL REGULATIONS TEXT* California Privacy Protection Agency (Feb. 2, 2023), https://cppa.ca.gov/meetings/materials/20230203_item4_text.pdf.

2 Va. Code § 59.1-575 (2021) https://law.lis.virginia.gov/vacodefull/title59.1/chapter53/.

3 Colo. Rev. Stat. § 6-1-1301 (2021) https://leg.colorado.gov/sites/default/files/2021a_190_signed.pdf; *see related VERSION 3 OF PROPOSED DRAFT RULES*, Attorney General of Colorado (Jan. 27, 2023), https://coag.gov/app/uploads/2023/01/CPA_Version-3-Proposed-Draft-Regulations-1.27.2023.pdf.

4 Conn Pub. Acts 22-15 (2022) https://www.cga.ct.gov/2022/ACT/PA/PDF/2022PA-00015-R00SB-00006-PA.PDF.

5 Utah Code § 13-61 (2022) https://le.utah.gov/~2022/bills/static/SB0227.html.

6 *#StartupsEverywhere Profile Katherine Grill, Co-Founder & CEO, Neolth*, Engine (Mar. 18, 2022), https://www.engine.is/news/startupseverywhere-walnutcreek-ca-neolth.

7 *See, e.g.*, GDPR Shield, https://gdpr-shield.io/; *see generally Comments of Engine Advocacy in response to Commercial Surveillance ANPR, R111004*, §II Engine (Nov. 21, 2022), https://engine.is/s/Engine-FTC-Privacy-ANPRM-Comments.pdf

8 *#StartupsEverywhere Profile: Andrew Prystai, CEO & Co-Founder, Event Vesta*, Engine (Oct. 29, 2021), https://www.engine.is/news/startupseverywhere-omaha-ne-eventvesta

9 Per our conversations with startups for this research. These figures generally adhere to averages reported in robust data sources, *e.g.*, *Ecosystems*, Startup Genome, https://startupgenome.com/ecosystems (reporting average software engineer salaries for various ecosystems); and *the State of the Startup Ecosystem*, 15-16 Engine (Apr. 2021), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/60819983b7f8be1a2a99972d/1619106194054/The+State+of+the+Startup+Ecosystem.pdf (reporting average annual software engineer salaries for four select ecosystems of various sizes).

10 *See, e.g.*, *2022 Global Privacy Benchmarks Report*, TrustArc (2022), https://trustarc.com/pdf20/2022-global-privacy-benchmarks-report.pdf.

11 *#StartupsEverywhere Profile: Jeff Wigh, Founder & CEO, Bryght Labs*, Engine (Feb. 4, 2022), https://www.engine.is/news/startupseverywhere-overlandpark-ks-bryghtlabs.

12 *Comments of Engine Advocacy, supra* note 7, at §V.

13 *#StartupsEverywhere Profile: Camila Lopez, Co-Founder, People Clerk*, Engine (Nov. 4, 2022), https://www.engine.is/news/startupseverywhere-miami-fl-peopleclerk.

14 *See, e.g.*, *Startups, Content Moderation, & Section 230*, Engine (Dec. 2021), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/61b26e51cdb21375a31d312f/1639083602320/Startups%2C+Content+Moderation%2C+and+Section+230+2021.pdf; *Startups & the U.S. Patent System: Prioritizing Quality and Balance to Promote Innovation*, 9 Engine (July 2021), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/60f8579bae6a2d324b7440a2/1626888093336/Engine+Patent+Quality+Booklet+2021+7.21.pdf.

15 *The Coming "Privacy Troll" Problem*, Engine (May 31, 2019), https://engineadvocacyfoundation.medium.com/the-coming-privacy-troll-problem-4363695220d6.

16 *See related* Robin Feldman, *Patent Demands & Startup Companies: The View from the Venture Capital Community*, UC Hastings Research Paper (Oct. 28, 2013), http://dx.doi.org/10.2139/ssrn.2346338. ("100% of venture capitalists indicated that if a company had an existing patent demand against it, it could potentially be a major deterrent in deciding whether to invest." Similar deterrents to investment or M&A are present as the result of any pending litigation.); *See generally Exits, Investment and the Startup Experience: the role of acquisitions in the startup ecosystem*, 8-9 Engine (Oct. 2022), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/6356f5ccf33a6d5962bc7fd8/1666643406527/Exits_Investment_Startup_Experience_role_of_acquisitions_Report_Engine_Startup_Genome.pdf.

17 *Tools to Compete: Lower Costs, More Resources, and the Symbiosis of the Tech Ecosystem*, Engine and CCIA Research Center (Jan 2023). https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/63d2b8d-5bec96f502264fd1f/1674754266044/FINAL_CCIA-Engine_Tools-To-Compete.pdf.

18 *#StartupsEverywhere Profile: Mandy Poston, Founder & CEO, Availyst*, Engine (June 24, 2022), https://www.engine.is/news/startupseverywhere-philadelphia-pa-availyst.

19 *See, e.g.*, *State of the Startup Ecosystem*, *supra* note 16, at 19-20.

20 *#StartupsEverywhere Profile: Ben Brooks, Founder & CEO, PILOT*, Engine (July 29, 2022), https://www.engine.is/news/startupseverywhere-newyork-ny-pilot.

21 *#StartupsEverywhere Profile: Tani Chambers, Founder & CEO, RAVN*, Engine (Jan. 20, 2023), https://www.engine.is/news/startupseverywhere-newyork-ny-ravn.

Exits, Investment, *and the* **Startup Experience**: *the role of acquisitions in the startup ecosystem*

presented by

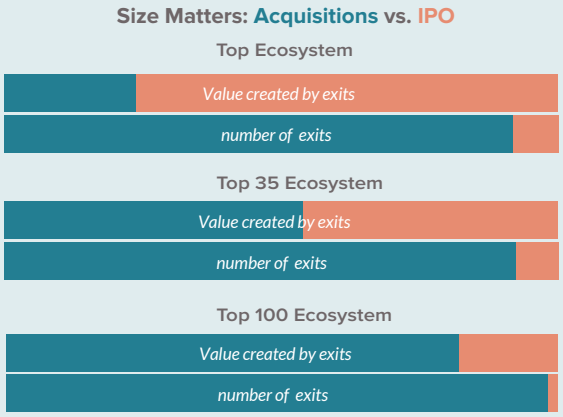
Engine Startup Genome

THE STARTUP ECOSYSTEM NEEDS ACQUISITION AS AN EXIT PATH.

Startup exits and investment are two intimately related and important drivers of the dynamism that is critical to economic growth and innovation in the startup ecosystem. But exits via acquisition are particularly important to startups—especially those located outside of hubs like Silicon Valley. Startup acquisitions promote the building of knowledge, recycling of talent, and flow of capital through the ecosystem. Each of those components are key to building new startups and stimulating the investment needed to grow them to scale.

The overwhelming majority of startup exits everywhere are via acquisition.

Acquisition is the most frequent startup exit in every ecosystem. In large ecosystems like Silicon Valley that have large IPOs, the majority of exit value comes from those IPOs. In smaller ecosystems, acquisitions create nearly all of the exit value. In most parts of the country, acquisition is the only meaningfully available exit path for startups.



Founders say acquisitions are a good thing, and policymakers shouldn't make it harder to be acquired.

> ***" The acquisition of 21 by Perforce was a success*** *and the right move for us, and I hope policymakers* ***don't make these sorts of transactions more difficult."***
> **~ Shani Shoham,** CEO, 21 Labs (acquired by Perforce)

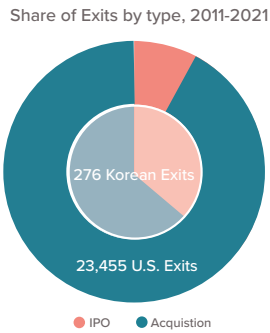
> ***"Being acquired is a desirable startup exit*** *path, and restricting it will lead to less capital and less startup competition."*
> **~ Steven Cox,** Founder & CEO, TakeLessons (acquired by Microsoft)

> *"being acquired was* ***a really good outcome*** *for Safaba"... and "****a transformational professional opportunity*** *and financial outcome for our entire team."*
> **~ Alon Lavie,** Cofounder & CTO, Safaba (acquired by Amazon)

> *"Founders should be able to pursue the pathway to* ***exit that is right for them..."***
> **~ Jewel Burks Solomon,** Founder & CEO, Partpic (acquired by Amazon)

ACQUISITIONS AND IPOS AREN'T INTERCHANGEABLE.

IPOs are out of reach for many companies, extremely rare in most parts of the country, and early IPO regimes in other countries suffer from issues with performance and often aren't true exits for startup founders or investors—the kind that provide returns and deliver dynamic benefits to their local startup ecosystems.



Engine Startup Genome

For more information, visit: engine.is

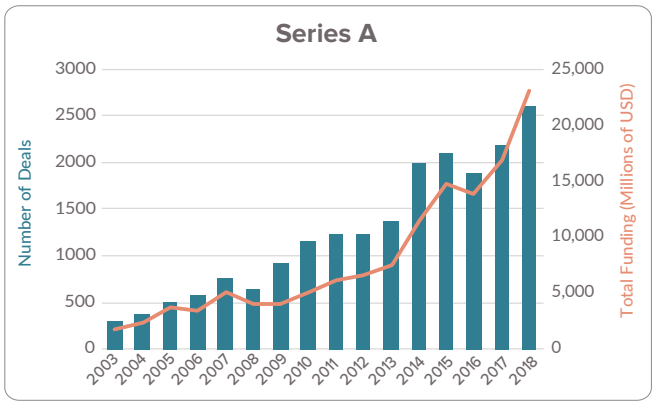
Engine

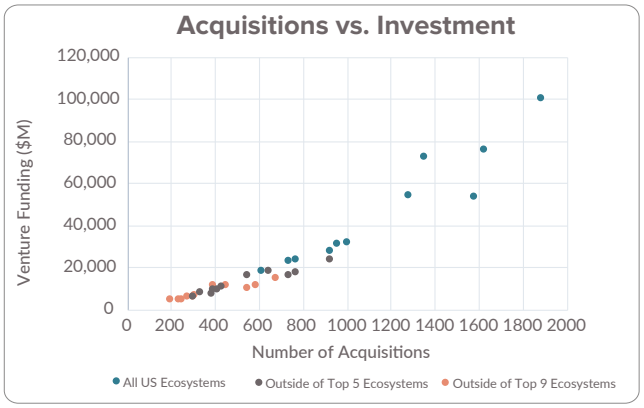
CONTENTS

INTRODUCTION

The U.S. startup ecosystem is defined by dynamism. Startups are constantly being founded, earning investment, growing, exiting, and—yes—failing in cities and towns all across the country. Startup exits and investment are two intimately related and important drivers of this dynamism critical to economic growth and innovation in the startup ecosystem. Startup exits—both those that are profitable and those that are not—promote the building of knowledge, recycling of talent, and flow of capital through the ecosystem. Each of those components are key to building new startups and stimulating the investment needed to grow them to scale.

Last April, we released a report on the State of the Startup Ecosystem intended to give policymakers an overview of the health of American startups and facilitate detailed benefit-cost analyses for individual policy proposals across a range of issues. Through that report, Engine, together with Startup Genome and the Charles Koch Institute, demonstrated the health and tremendous growth of the ecosystem, the relationship between exits and investment, the especially strong and positive relationship between acquisitions and startup investment, and the particular importance of exits via acquisition in more rural ecosystems.





Over the past year, policy conversations focused on the technology sector have turned into legislative proposals, and new leadership at the antitrust enforcement agencies have begun the process of rewriting the merger guidelines. Effective antitrust enforcement against truly anticompetitive mergers and acquisitions is necessary for a thriving startup ecosystem, but imbalanced competition policy that leads to too many "false positives" is likely to harm the startup ecosystem. Recent policy developments like these could lead to overzealous enforcement and threaten to restrict the ability of startups to exit, particularly if they want to be acquired by a larger firm.

Through this report, Engine and Startup Genome build upon the previous report by further demonstrating the relationship between startup exits, investment, and talent; the particular importance of startup acquisitions in the startup ecosystem; and how these relationships in the U.S. compare to non-U.S. ecosystems. This report also seeks to emphasize the startup experience with acquisitions with data and through a series of startup founders' firsthand experiences. Taken together, these reports should give policymakers the solid foundation they need to advance policies that will lift up startups and avoid potential pitfalls and unintended consequences.

GLOSSARY

Exit

Generally, an exit occurs when a startup investor or founder liquidates some or all of their shares/ownership in the company. This may come in the form of cash, debt, or equity in another company. Profitable exits return money to investors, founders, and other shareholders (like early employees). Unprofitable exits may return some funds to investors, provide a soft landing to founders and employees in the form of jobs (e.g., at the acquiring firm). Unprofitable exits can also simply involve failure and shutdown.

Acquisition

An event in which a company obtains a majority—if not all—of the assets of another company and is now in primary control.

Initial Public Offering (IPO)

The first case of selling shares to the public by a previously private company in order to generate capital. After an IPO, a company would generally no longer be considered a true startup.

Merger

An agreement between two separate companies to combine together into one entity.

Runway

Refers to the amount of time a startup can operate before they need to raise additional capital. Often measured in months, runway can be thought of as the amount of time before a startup runs out of money.

Funding Round

A distinct period where startups seek and receive investment from one or more investors. Usually, startup founders will pitch several dozen investors, generate interest from several, and receive investment from a few. Following pre-seed/seed investments, funding rounds are typically lettered—Series A, B, C, and so on. To reduce noise in the data, Startup Genome combines all seed, pre-seed, angel, and pre-Series A funding rounds to report as seed/angel funding, and removes those rounds that are less than $125,000.

Seed

Seed is the earliest round of formal investing, where money is exchanged for equity within the company or convertible debt. It primarily comes from the personal networks of the startup or angel investors, but some venture capital firms will invest at the seed stage as well.

Angel

Angel investors are individuals or small groups of investors that provide financial capital from their own personal funds.

GLOSSARY

Series A
A large scale investment round (usually in millions) that occurs after the seed stage of a startup. This financing generally comes from institutional investors like venture capital or private equity firms.

Series B+
After a startup has raised its Series A round, the next investment rounds continue with lettered rounds B, C, D, etc. which are usually successively larger. Series B+ referenced in this report refers to all venture capital rounds from Series B onward. Like Series A, this financing generally comes from either venture capital or private equity firms.

Startup
In this report, a startup is a U.S.-based technology and innovation company founded after 1995. Startups are tech-enabled, high-growth companies with scalable, repeatable business models.

Startup Ecosystem
A network of individuals, startups, and other community stakeholders that utilize their resources and interact with one another to promote innovation within their region. Startup Genome ranks ecosystems using a number of factors including: performance, funding, market reach, talent, connectedness, and knowledge.

Ecosystem Value
A measure of the economic impact of the ecosystem, calculated as the total exit valuation and startup valuations over a 30-month period.

Venture Capital
A form of institutional investment, venture capital is capital pooled together from investors and given to startup companies in exchange for equity within the company. Investors might be high-wealth individuals, foundations, pension funds, endowments, or other institutions, and they are known as limited partners. Their pool of capital constitutes a venture fund, which is managed by the venture capital firm. The general partners at the firm choose the startups to invest in, which are typically technology-based with high-growth potential.

METHODOLOGY

Data presented in the report were provided by Startup Genome, a world-leading innovation policy advisory and research firm. Through partnerships and extensive survey research, Startup Genome has access to a comprehensive picture of the startup ecosystem. The main datasets integrated and consulted for this report include those from Crunchbase, Dealroom, Pitchbook, and Orb Intelligence, in addition to Startup Genome's original research and data from Forbes 2000, GitHub API, International IP Index, Meetup.com, OECD R&D Spending, Salaries Data from Glassdoor, Salary.com and Pay-Scale; Shanghai Rankings; Times Higher Education Rankings; Top 800 R&D Hospitals, Webometrics; USPTO and WIPO; and World Bank Ease of Doing Business.

In the course of this research, Engine and Startup Genome have conducted several interviews with entrepreneurs, startup founders, venture capitalists, and other investors, both in the U.S. and abroad. These conversations help to provide additional context to the data presented in the report, reflect the local knowledge of individuals operating in startup ecosystems around the globe, and underscore key considerations for policymakers in related policy debates. A selection of these conversations are presented here as brief "startup stories."

Startups in this report are U.S.-based technology and innovation companies founded after 1995. Startup ecosystems tend to be grouped based upon a geographical location and defined radius. Startup ecosystems are a network of individuals, startups, and other community stakeholders that utilize their resources and interact with one another to promote innovation within their region. Startup Genome ranks ecosystems using a number of factors including performance, funding, market reach, talent, connectedness, and knowledge.

For clarity, individual analyses in the report that include statistical analyses, non-annual data, or adjustments based upon, e.g., growth rate are explained where they are presented rather than this section.

A note on the Macroeconomy

Macroeconomic factors like inflation, geopolitical conflict, and pandemics impact the startup ecosystem—the availability of capital, and the size, type, and frequency of exits are influenced by developments in the economy writ-large. Typically the largest companies in a sector are impacted first (for example, in the public markets), then late-stage startups before trickling down to early stage. From the beginning of 2022 through the end of May, Nasdaq 100 Technology Sector index and the S&P 500 have each lost about a quarter of their value. Large venture capital firms have published memos to guide their portfolio companies through uncertain, down markets.[1] Inflation remains at highs not seen in decades.[2]

Due to their recency, this report does not seek to further unpack these developments. Sometimes sharp pullbacks in startup investment based upon stock market performance quickly reverse and aren't felt at the earliest stages, which is what happened in 2016—but the present downturn is underpinned by additional factors not present then.[3] It is difficult to predict how the current situation will play out, and—because it is still unfolding—it is impossible to put in the context of the data presented in this report. Indeed, preparation of the data for this report began before conditions in the markets turned for the worse earlier this year.

Despite this, the conclusions of the report remain valid and instructive for policymakers. The well-established relationships between exits and investment, importance of acquisitions for the startup ecosystem, and prescient lived experiences of founders endure. With the macroeconomic situation uncertain and potentially threatening to the startup ecosystem, it is especially important to root policy proposals impacting startups in a sound understanding of the ecosystem and the relationship between startup exits—especially via acquisition—and investment in startups.

EXIT LIFECYCLE: ACQUISITION

Startups that come to be acquired follow many different paths to acquisition, depending on the unique details of their situation. Over half of startup exits via acquisition are profitable—providing return on investment for investors, founders, and other shareholders like early employees.[4] Some startup exits via acquisition are not profitable and typically come after such startups have tried, but were unsuccessful at raising additional capital.[5] These acquisitions return some of the initial investment back to investors, tend to offer a 'soft landing' for founders and key talent in the form of roles at the acquiring company, and are preferable to failing worthless. Each startup may have a unique road to acquisition, but startup acquisitions share common elements. Here are some of the key steps in the acquisition process.

LAUNCHING AND GROWING A COMPANY

As startup founders grow their companies, build their products, attract investment, and go to market, they have in mind long-term goals, or an exit strategy, for their company. Consistently, over half of founders say acquisition is their realistic long-term goal for their startup.[6] The average age at acquisition for startups has steadily been around five years, but a large standard deviation underscores the range of ages and stages at which startups are acquired.

STRATEGY AND PREPARATION

Startups can seek to be sold, or they can be approached by potential buyers. Some startups are acquired or merge with other startups that are just a bit farther along than they are. Other startups are acquired by large, established firms that might conduct several such transactions in a given time period. Each case presents differences in strategy and negotiating power, but in either case, a startup is well aware of their valuation. Startups looking to sell may also have prepared financial statements and documents outlining their business to share with potential buyers. Institutional investors in a startup—who often have a seat on the board of directors—are likely to have been through the acquisition process several times and can play a critical role in facilitating the transaction.

SOLICITATION AND NEGOTIATION

After a startup has received an offer, they may solicit others and will negotiate the valuation and potential earnouts based on expected future performance of the company. The startup and acquiring firm will iron out other details to be included in a letter of intent—like the purchase price, how the buyer is going to pay, what happens to employees, and other details depending on the situation.

LETTER OF INTENT

After the price and key terms of the transaction are sorted out, they will be enumerated in a letter of intent that is signed by both parties. Letters of intent are likely to have both legally binding and non-binding provisions. Almost every letter of intent will include exclusivity provisions—that the startup won't continue seeking other buyers for some enumerated period of time—and confidentiality ones—that the buyer won't disclose the confidential information they learn through the due diligence process to others.

DUE DILIGENCE

Ahead of the final purchase agreement and exchange of assets, the buyer conducts due diligence to ensure that the information they based their offer upon was accurate. The due diligence process is an especially critical period for startups. If there is a material discovery in due diligence that leads the acquirer to walk away from the transaction, that sends a signal to other potential acquirers, which may cause the other offers the startup initially received or could potentially receive to evaporate or be greatly reduced.

PURCHASE AGREEMENT AND SALE

After the due diligence process has concluded, the startup and acquirer enumerate the terms of the transaction in a purchase agreement, including any adjustments based upon discoveries in due diligence. The purchase agreement is the binding contract memorializing the transaction. Large deals exceeding certain thresholds have to be reported to antitrust authorities prior to consummation of the transaction. Sometimes these filings are submitted earlier in the process, once key terms of the deal have been enumerated in a letter of intent.

NEXT STEPS

Individual terms and characteristics of each transaction will determine what startup founders do next after their company is acquired. Startup founders are sometimes paid in stock of the acquiring firm which vests over a certain period of time. During this time, the founders often join and work at the acquiring firm. After the vesting period, many leave and join or begin new startups. Startup founders and key employees routinely stay in the startup ecosystem, founding new startups, becoming investors, and mentoring others.

EXIT LIFECYCLE: IPO

Startups looking to go public have a few avenues to access the public markets including direct listing, special purpose acquisition company (SPAC), or reverse merger. Traditional initial public offerings (IPOs) remain the most popular way for startups to go public, even if each of those options may have merits for individual companies. Key steps in the IPO process, which can take six to 12 months, are explored in this diagram.

BEGINNING AND GROWING A COMPANY

While startups may be acquired at many different stages and levels of (un)profitability, those going public via IPO are later-stage—older and larger. Indeed, there are substantial regulatory compliance burdens associated with being a public company and it can cost millions of dollars annually. A company also generally needs institutional backing to go public, as illustrated below. As such, startup IPOs are often concentrated in the largest ecosystems. Still, just under a fifth of startup founders say their long-term goal is to go public through an IPO, but few make it there—less than 10 percent of exits in a given year are via IPO.[7]

SELECT UNDERWRITER(S)

Once a startup has decided to go public, they will select an underwriter—usually an investment bank—to manage the IPO and sell the shares to investors. Startups select underwriters based on the underwriter's plan for the process, but also upon their existing institutional relationships, reputation, and ability to sell the shares. An IPO can involve one or more underwriters. Having more underwriters helps reach more investors, which is especially common in larger IPOs.

DUE DILIGENCE AND REGULATORY FILINGS

The startup and its underwriters will conduct due diligence examining every aspect of the company. Barring a material discovery in due diligence, the underwriters will then send the Registration Statement to the Securities and Exchange Commission (SEC). Some startups may be exempted from certain otherwise applicable requirements—if they meet the definition and file as an Emerging Growth Company as set out by the JOBS Act—including certain disclosures and the number of audited financial statements.

ROADSHOW AND PRICING

The underwriters are responsible for setting a planned price range for the IPO. This process can include distributing a preliminary prospectus which helps assess investor interest. Underwriters and company leaders often go on a "roadshow" (sometimes virtually) across the country (and globe) to market the company to and take orders from prospective investors. Based upon orders from the roadshow, the underwriters will revise the planned price range for the offering.

ALLOCATION AND TRADING

After the shares have been priced, the underwriters will allocate them to investors. Once allocated, the stock starts trading and the public can buy and sell the shares on a stock exchange. Existing shareholders' private shares (those held by, e.g., founders, employees and private investors like VCs) are also converted and become valued at the public share price.

POST-IPO

Companies choose to go public to raise capital that will help them further grow their business and to provide an exit for investors and others, who can decide to eventually sell their shares and earn a return. After the company is public, there is typically a lockup agreement that prevents company insiders—including founders, employees, existing (pre-IPO) investors, and others—from selling their shares for a period of time, usually 180 days. Companies that are publicly traded are subject to additional regulation designed for investor protection, and compliance can cost the company several million dollars annually.[8] Companies that have gone public as Emerging Growth Companies are also exempted from some of these requirements for as long as they have EGC status, which can be as long as five years. And there can be other costs to going public, for example additional public scrutiny, less founder control, and pressures from activist investors.

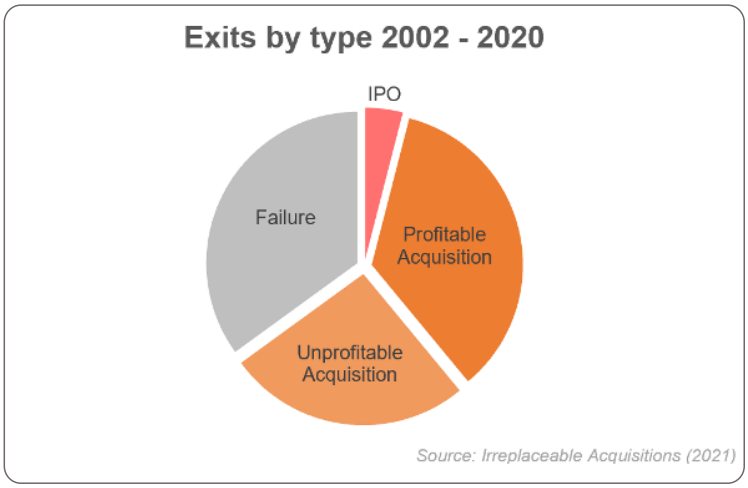
STARTUP EXITS

Overview

Broadly, there are three types of startup exits: going public, being acquired, or failing. Exits are a critical moment in the lifecycle of a startup—after an exit the company is likely to no longer be considered a startup: it will either be a public company, be part of the acquiring firm, or cease to exist.

In successful, profitable exits, founders are rewarded for the blood, sweat, and tears they have put into building the company, and investors earn a return. Both exits via acquisition and via IPO can be successful, profitable exits, but they vary in their frequency, relationship to new investment in startups, and accessibility to more-rural and smaller companies.

Overall, IPOs are much more rare than acquisitions. Our earlier report on the State of the Startup Ecosystem found just 10 percent of exits from 2008 to 2018 were via IPO (not including failures).[9] The remaining 90 percent were acquisitions. Another paper found that IPOs made up just four percent of all startup exits between 2002 and Q12020 (including failures and shutdowns). Acquisitions meanwhile accounted for 61 percent of exits. (And 35 percent of the startups in the dataset failed).[10] This (in)frequency of IPOs is consistent with founders' long-term expectations for their startups—in one survey, 58 percent said their long-term goal was to be acquired while 17 percent said IPO.[11]



In addition, IPOs are more concentrated in parts of the country that have larger, more established startup ecosystems and are more weakly associated with investment in new startups when compared to startup acquisitions. As a result, the availability of exit via acquisition is of greater importance to startups and investors outside of top ecosystems like Silicon Valley, New York, Boston, Los Angeles, and Seattle.

Unfortunately, not all exits are profitable—for example, if a startup is acquired for less than the company's previous valuation—but these unprofitable exits are preferable to failing worthless and similarly important to the startup ecosystem. These exits can provide a soft landing to founders and investors of companies that have run out of alternatives—they're out of runway, can't raise additional funds from investors, and are too small or unprofitable to raise funds by going public.[12] Through acquisition, investors are able to recoup some of the original investment, and founders and employees might be given a job at the acquiring firm, allowing them to build their resumes ahead of their next venture.

Building on this prior research, the rest of this report takes a deeper look at exits and investment in startups at an ecosystem level.

Exits and Investment

Examining exits and early stage investment at an ecosystem level shows, unsurprisingly, that exits fuel investment. The data should emphasize the obvious role exits play in investment, and additionally factor into global policy questions of how companies should be allowed to exit, and whether and to what extent the capital stays in an ecosystem after an exit.[18]

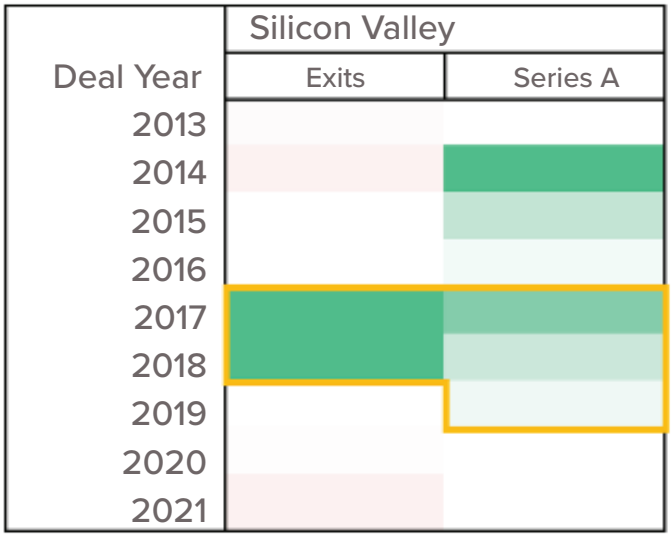
The adjacent heat map looks at the globally-adjusted yearly growth rates of the value of exits and the value of series A investments in a selection of startup ecosystems. To calculate the adjusted growth rate, Startup Genome first calculated adjusted values (with the globally-adjusted value being equal to the difference between the subsequent year unadjusted value and the product of the unadjusted value and global growth rate) before using these adjusted values to calculate the globally-adjusted growth rate. Adjusting the data should diminish the prevalence of some confounding variables like global economic trends, for example. This is important since overall economic trends necessarily impact investment and exit activity.

Exits in the Investment Model

Much ink has been spilled describing the venture capital (VC) investment model and the role of exits in it.[13] Over the decades, the portfolio of companies that venture investors fund has evolved, but the basic model has remained.[14] And as VC has emerged and emerges in new regions—including those with important societal, structural, and cultural differences—exits (somewhat obviously) continue to play a critical role.[15] It is worth briefly describing the model here.

While certainly not the only type of startup financing—and not necessarily the only type captured here—venture capital is the most prominent form of institutional investment in startups, and very few startups grow very large without it.[16] Generally, venture capital is capital pooled together from investors and given to startup companies in exchange for equity in the company. Investors might be high-wealth individuals, foundations, pension funds, endowments, or other institutions, and they are known as limited partners. Their pool of capital constitutes a venture fund, which is managed by the venture capital firm. The general partners at the firm choose the startups to invest in, which are typically technology-based with high-growth potential. A representative of the VC firm will often sit on the startup's board to monitor and guide the company and may provide additional funding as it grows. Once the startup successfully exits, capital is returned to investors, a new fund is formed and the cycle begins anew.

Startup exits are critical to the investment cycle in the innovation ecosystem—successful exits provide returns for investors and founders. That fact, or the prospect of it, is what encourages investors to fund startups and can also be part of what encourages founders to launch in the first place. And investors fund new startups with the profits they earn from prior investments, while founders often launch new startups, become investors themselves, or both. This is rational investor behavior most of us can connect to—investing with risk and potential return in mind, and reinvesting returns, is something most of us do with our retirement savings, for instance.[17]



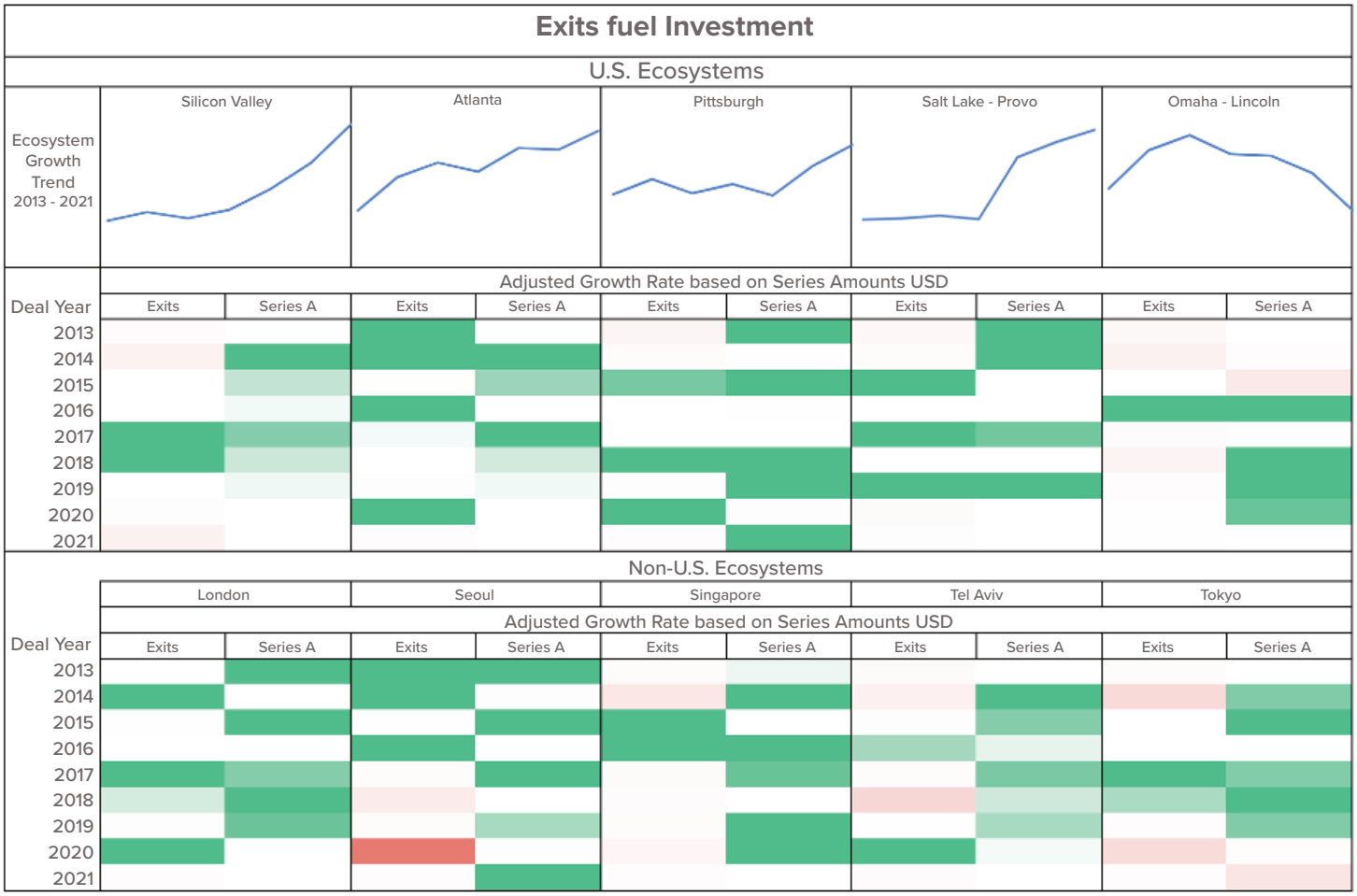
The U.S.-based ecosystems represent a range of size, level of development, geographic location, and predominant industry subsector. Non-U.S. ecosystems represent a selection of global benchmarks. For U.S. ecosystems, trendlines of ecosystem value are presented to lend additional context. Ecosystem value is an economic metric reflecting two and a half years of data ending in the reference year.

Dark-green boxes represent growth rates of 100 to 1000 or more percent. Medium-green boxes represent growth rates of 50 to 100 percent, and light-to-faint-green boxes represent growth rates between zero and 50 percent. Red boxes follow the same pattern, but denote rates of decrease, meaning darker red is more negative.

The heat map below brings into clear view the relationship between exits and investment that has been shown elsewhere.[19] When we see an increase in exits, we see an increase in investment in the same year or an adjacent year (usually both). We see this happen in the world's largest startup ecosystem (Silicon Valley) and in the smallest presented here (Omaha-Lincoln). We see it in both the domestic ecosystems and the foreign ecosystems.

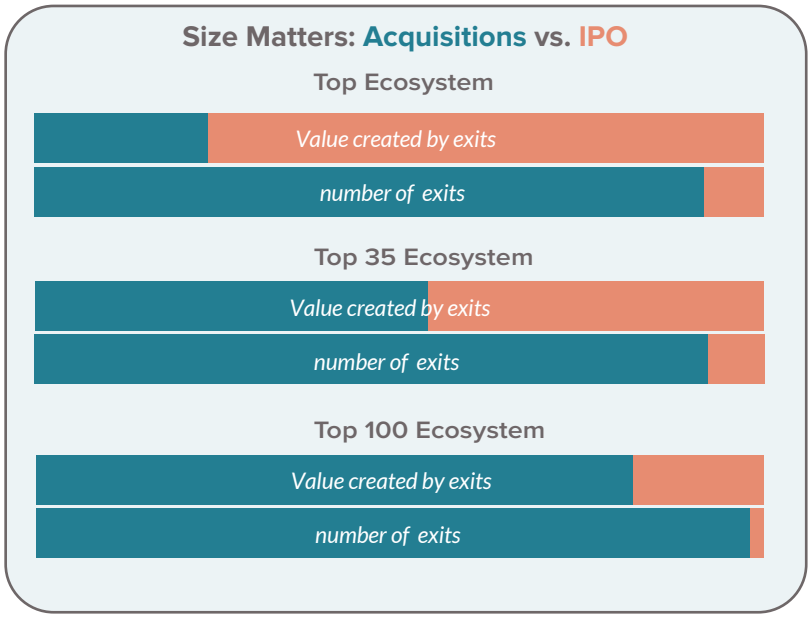
Of the 14 increases in exits that occur in the selected U.S. ecosystems, 13 are accompanied by an increase in series A in the same year or immediate subsequent year, or about 93 percent of the time. For non-U.S. ecosystems this happens 12 times out of the 13 there is an increase in exits, or about 92 percent of the time.

Notably, the chart lets us visualize the impact on investment as described in other scholarship. A 2022 paper describes the initially large impact on startup investment of acquisitions of startups by 'Big Tech' companies that then diminishes over time following the exit event.[20] That relationship is visible here, e.g., in Silicon Valley, Atlanta, and elsewhere—look for the dark-green bars that get progressively lighter.



IPO OR ACQUISITION: KEY DIFFERENCES FOR STARTUPS

While IPOs and acquisitions can both be successful exits that bring positive effects for the ecosystem, it is important to compare the two, given ongoing policy conversations that could result in fewer acquisitions. Looking at what exits happen where is instructive for current policy debates and brings into clear view the importance of acquisitions. In this section, we look at the five U.S. ecosystems included above. Again, they represent ecosystems at different stages of development. Each also varies in geography, demography, proximity to talent pools, and predominant industry subsector. This analysis can also help inform policymakers interested in, e.g., expanding the startup ecosystem and supporting innovation outside of Silicon Valley.

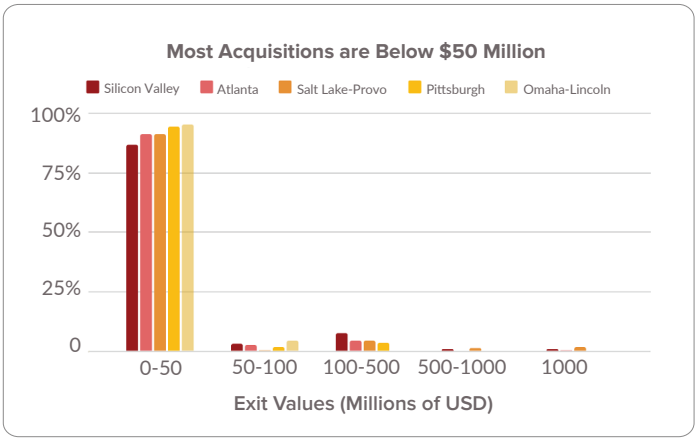


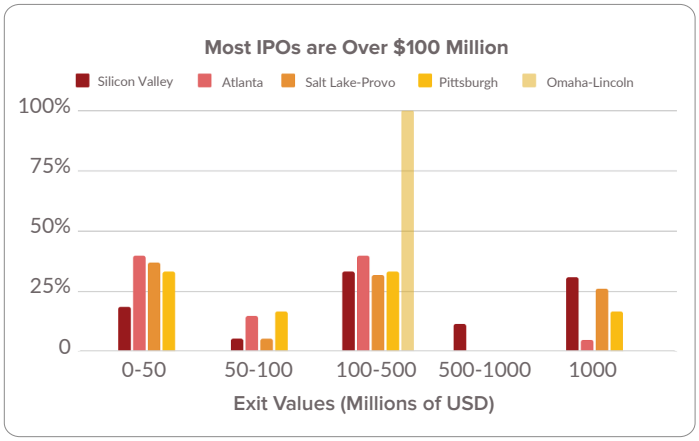
To see the differences in frequency and size of IPOs and acquisitions in each ecosystem, we look at the share of exits by type, the exit value, and overall data on exits. In the largest ecosystem, Silicon Valley, IPOs are responsible for most of the exit value. This diminishes progressively as you move to smaller ecosystems Atlanta, Salt Lake-Provo, Pittsburgh, and Omaha-Lincoln. A similar progression occurs when considering the share of exits by type. IPOs make up a greater share in Silicon Valley which diminishes as you move to Omaha-Lincoln (which only experienced one IPO one of these 10 years). For greatest detail, you can view individual ecosystem charts in the appendix. For the interest of space, a summary chart is presented here with Silicon Valley, the top ecosystem globally, Salt Lake-Provo, a top 35 U.S. ecosystem, and Omaha-Lincoln, a top 100 U.S. ecosystem.

On some level, this shows us what we already knew: IPOs are concentrated in the top ecosystems and tend to be out of reach for startups in smaller ecosystems. But it puts an exclamation point on the importance of exits via acquisition in smaller ecosystems—all of the dynamic benefits to flows of talent and capital that are brought by exit events are meaningfully only available through acquisitions. And this is consistent with the correlation analysis Engine and Startup Genome produced in the earlier report, which showed a strong, positive correlation between acquisitions and investment. As you remove top ecosystems from the data, the relationship between startup exits by acquisition and startup investment gets stronger and more positive.[21]

The data also confirms something else we knew: companies going public tend to be older and have higher valuations. An overwhelming majority of startup acquisitions in each of these ecosystems are below $50 Million. Meanwhile, the majority of IPOs are over $100 million. These differences have implications for company success.

Many companies valued below $50 million cannot conceivably succeed as public companies. A nationwide dataset shows that 40 percent of the companies that have gone public for less than $50 million have since failed.[22] Reviewing the IPOs under $50 million included above reveals similar results. A few of the companies are trading on foreign exchanges. Several of those that went public on the NASDAQ or NYSE are now trading over-the-counter, sometimes with a share price in fractions of a cent.





Going public too soon is risky for startups because it makes it harder to raise additional capital needed to scale. Public companies lose control of their share price, and their valuation is no longer likely to be set by those with knowledge of properly valuing startups. This can make an additional raise too expensive, or, especially if the share price is falling (e.g., as discussed above) make the company undesirable to prospective investors.

Institutional backing is likewise important for helping the company to succeed once public.[23] IPO underwriters typically perform sales-functions to sell the shares to investors. And once public, investment banks analyze and recommend (as appropriate) the stock to their clients. For small IPOs, there tend to be fewer underwriters (which are unlikely to be top-tier firms), and the stock is unlikely to be tracked by analysts (or by as many) at investment banks. Both of these diminish the likelihood of success as a public company in terms of share price. And it is important to note the differences in proximity of such key institutions—there are fewer in smaller ecosystems—which is an important factor for both the frequency of IPOs there and the success of the companies that do go public.

Finally, no discussion of U.S.-based IPOs would be complete without discussing the regulatory burdens and additional scrutiny that comes with being a publicly traded company. The Sarbanes-Oxley Act (SOX) sets out the regulatory framework for public companies, and the cost and complexity of compliance can easily exceed $1 million annually, which can be out of reach for many startups and contribute to fewer companies going public or delaying that move until they are larger and older.[24]

SOX and its consequences for startups and the public markets are instructive for current debates about acquisitions in the startup ecosystem. Sarbanes-Oxley was legislated in response to a series of high-profile accounting scandals. Of course, no member of Congress or the public is or was in favor of corporate fraud in their consideration of Sarbanes-Oxley, but several members of Congress did warn of the consequences of burdening capital formation for small companies like startups through SOX. Then-Representative Jeff Flake (R-Ariz.) cautioned against proceeding without knowing "what cost we're going to impose, particularly on small businesses."[5] Sens. Phil Gramm (R-Texas) and Kit Bond (R-Miss.) respectively voiced concern that the law would "use up the resources" of small companies, and "damag[e] the economic framework for small companies to reach our capital markets."[26] Given the impacts on IPO frequency, IPO company age, and of compliance costs, those concerns have indeed borne out.

Likewise, today, no policymaker or member of the startup ecosystem is in favor of illegal anticompetitive conduct as they warn of the consequences of burdening startups through poorly crafted competition policies. Creating burdens on startups' ability to exit, especially via acquisition, "risks similar unintended consequences" as those effected by SOX, as one startup founder put it.[27]

EXITS AND THE STARTUP EXPERIENCE

Engine strives to be the voice of startups in government, and our work is informed by our network of thousands of startups located in every state and congressional district all across the country. This project is no different. In the course of this research, we spoke with dozens of startup founders to hear about the firsthand experiences of having their company be acquired. They represent companies across a range of ecosystems, deal sizes, and acquirers. Below is a sampling of some of those stories, which should be instructive for how acquisitions fit into the broader startup ecosystem.

Startup Aquisition Experience: CARLYPSO

Acquired by Carvana • San Carlos, California
Nicholas Hinrichsen, Cofounder and CEO

Originally a peer-to-peer platform for buying and selling used cars, Carlypso is an online platform that gives customers access to wholesale inventory and helps throughout the buying process by performing inspections and arranging delivery.

I came to the U.S. from Germany to go to business school at Stanford, where I met my cofounder, Chris. After we graduated, we started Carlypso—with the goal of building something like an Amazon of used cars. We went through Y Combinator, raised $10 million in venture capital funding and ran the company for about four years.

Our goal at the outset wasn't necessarily to be acquired, but rather to build as big as we could. We discovered that running a car retailing company is really, really hard and capital intensive—particularly what we were building—because success required vertical integration, essentially being three companies in one: a logistics company, a bank, and a car dealership. We became very good at two of these pieces, i.e. the car dealership and the logistics company. But our inability to provide financing, especially to buyers with low credit scores, led us to sell our business to Carvana. Carvana had inherited the lending business from its parent company Drivetime, and so we decided selling to them seemed like a good option.

Venture investors have an expectation for a high exit multiple. Returning capital to investors was important. At the point of the sale, the intellectual property we had created had become very valuable. The technology, however, wasn't as useful without the team that had built it. Therefore, ensuring the best deal for our team—making sure they had a job that paid well where they could apply what they learned and eventually move on—was 100% aligned with our investors' financial interests. Everyone on our team of about a dozen were able to join Carvana.

Looking back, I wish we could have stayed independent and been the successful company in a position to acquire, but this was the second best possible outcome for us. We couldn't have built what Carvana had inherited.

I worked at Carvana in a few leadership roles for a few years, in addition to advising and investing in startups. In 2020, my co-founder and I left to build a new startup, leveraging our deep knowledge of the industry to help consumers with their auto loans in particular and their consumer loans in general. Since then, we've raised $41M in venture funding from amongst others Andreessen Horowitz and our strategic partner CUNA Mutual Group. We're on a mission to turn Credit Unions into FinTechs and help consumers with their financial well-being.

Startup Aquisition Experience: TAKELESSONS

Acquired by Microsoft • San Diego, California
Steven Cox, Founder and CEO

TakeLessons is a learning platform where instructors offer teaching services for sale and individuals receive lessons for languages, tutoring, music, and more, either online or in-person.

I founded TakeLessons in 2006 after noticing a disconnect between people looking to learn and those who could actually teach them. What we recognize today as ecommerce platforms or marketplaces were around—eBay, for example—but connecting buyers and sellers of services was still novel. I started the company out of a spare-bedroom, self-funded, and worked at night with teams in India to build the first version of a product, initially focused around music lessons. We bootstrapped the business for a few years before friends and family funding, and eventually institutional venture capital.

Before being acquired by Microsoft in 2021, we made two acquisitions ourselves to advance the business. One helped us to expand into a new offering—building out our network of instructors at a discount—while the other acquisition added a social aspect to our core offerings around music.

The decision to be acquired was a strategic one, reflective of our understanding of the cycles startups go through. Early on in 2012, business was going well and we started receiving offers from would-be acquirers. While we explored them, we ultimately decided not to pull the trigger—we were just getting started and had a lot of opportunity ahead of us. At various points over the next several years there were times where we would have been open for an acquisition, but there weren't any buyers. So when we experienced the boom in online learning during COVID, we tested the waters and received interest from both strategic buyers and private equity firms, confirming it was a good time to potentially join forces with a strategic buyer.

We were courted by multiple parties, and we were thrilled to be acquired by Microsoft—the second largest company in America. Obviously, key considerations like pricing, terms, and probability of closing were important, but for us, Microsoft's strengths paired well and they had the resources to grow TakeLessons and a shared interest in empowering providers to make a better living doing what they love. Equally important—and I hope this is a priority for every founder—the day after we were acquired, all of our employees had jobs at Microsoft.

The company is in great hands. This has allowed me to step back to a consulting role after spending the several months following the acquisition helping with the transition. I am now taking a breather a bit and thinking deeply about what I want to do next. I've joined the Board of Directors/Advisors for a couple marketplaces and/or ed tech companies, and I've started looking at government policy, social impact, and food tech space. I will certainly remain in the startup ecosystem.

Finally, I've been asked recently about big tech acquisitions that are made just to kill off new technologies. Personally, I haven't seen these "killer acquisitions" where a large company tries to stamp out a small one. It's possible, I suppose, but I find that larger companies are more interested in playing offense than defense.

Regarding policy, policymakers should be thoughtful about limiting mergers and acquisitions by big tech as a way of reigning in the major players. Being acquired is a desirable startup exit path, and restricting it will lead to less capital and less startup competition. Policymakers should also realize that immigration is an important key to startup talent. To compete in a global economy, startups need to hire the best and brightest employees from around the world. The employee-sponsored visa program remains broken, and Congress needs to make it easier for startups and other small businesses to navigate the immigration system. Finally, the protection of the Qualified Small Business Stock (QSBS) incentive is a key driver to allowing entrepreneurs and early employees to be rewarded for taking the risks to start and grow a new business. Without a doubt, the QSBS tax treatment helps the startup ecosystem as an economic engine.

Startup Aquisition Experience: **SAFABA**

Acquired by Amazon • Pittsburgh, Pennsylvania
Alon Lavie, Cofounder and CTO

Safaba is an automated translation solution for global enterprises' digital content, like websites, customer communications and more.

I spent most of my career in academia as a professor at Carnegie Mellon University (CMU) in the AI language technology space. In 2009, a cofounder and I started Safaba, which was essentially a spin-out of my research lab activities. Automated translation technology was evolving quickly at that time, mostly in research settings, and we identified an opportunity and need for commercialization. The technology was particularly advantageous for large, global enterprises—including Amazon, who initially approached us as a customer and really liked the product and expertise we offered.

A lot of our technology development was funded by the Small Business Innovation Research grant program and some investment capital from a few different entities. By the end of 2014, we were at the point of raising a series A round when Amazon approached us with an offer, and we ultimately decided to accept. We were a team of 12 at that point—mostly from the CMU research environment—and eight of us went full time into Amazon. At the time, Amazon was the only large tech company without a presence in Pittsburgh and we made clear early in the process that none of us wanted to move to Seattle. I convinced them that there is a lot of value to the talent and connections at the University, so as part of the acquisition they opened a corporate office here in Pittsburgh. I worked there as a senior manager for three and a half years post-acquisition, and the office has grown to 300-400 people, so I definitely pat myself on the back for being the person recognized as bringing Amazon R&D to Pittsburgh.

Focusing on the positives, I think being acquired was a really good outcome for Safaba. Ultimately, it was the right decision for the company, and it wasn't just financially lucrative for my cofounder and I, but it was a transformational professional opportunity and financial outcome for our entire team. The integration of the technology within Amazon went really well. And managing an R&D team in a large company also added another highly valuable chapter of experience to my career that I really appreciate.

Being acquired is not without its challenges, though, especially with a large company like Amazon. Integration from a culture standpoint is really tough and generates a lot of situations for people to become unhappy. We were a small startup with roots in the University research space, and so the transition to a large company like Amazon was difficult in terms of operational structure, rules and how organizations are managed at that scale. When it came to the acquisition negotiation process, we were also on a different playing field in terms of resources and experience, and so that was probably the biggest challenge for us as founders. Even where we did things right—we had done an immaculate job of clearly separating and documenting our IP in the technology transfer process with the University—there was friction with Amazon. We also had a long relationship with a top-tier legal team that we weren't able to leverage because they represented Amazon elsewhere, and Amazon wouldn't give a waiver to allow our legal team to represent us in the transaction.

Ultimately, I'm glad we saw the acquisition through, but I think there's a lot policymakers, startup supporters, and others can do to help empower startups in the acquisition process, particularly when the acquirer is a large company like Amazon. Shared tools and resources seem like a good place to start. Template agreements or standard terms might help founders understand what is standard in a contract, but wouldn't be very valuable if the acquiring companies are able to toss them aside in negotiations. And for startups, high-quality legal and business representation that you trust to negotiate on your behalf is critically important, as is ensuring your proprietary IP is clearly identified and well-documented to avoid the potential for issues in the acquisition process.

Today, I am an adjunct professor at CMU and a senior manager at a bi-national growth-stage scaleup called Unbabel. Unbabel is fundamentally in a similar AI translation technology space as Safaba, providing an AI-based platform for translation of large volumes of multilingual content for large enterprises. I knew the founders long before they actually started the company—the CEO actually got his Ph.D. at CMU. I opened an office for them here in Pittsburgh and largely oversee the AI technology side for the company. As a growth-stage scaleup, Unbabel is another interesting chapter in my career in the translation technology and NLP R&D space that rounds out my experiences outside of academia in terms of both founding and running a small startup and working at a large tech company.

Startup Aquisition Experience: CLOUDCHERRY

Acquired by Cisco • Salt Lake City, Utah
Vinod Muthukrishnan, Cofounder and CEO

CloudCherry is a customer experience software solution that helps companies manage the customer experience journey and increase customer retention.

Even though there were others in the customer experience market, we decided to create CloudCherry because we saw a gap that could be solved by approaching the problem with a customer perspective lens. Most contact centers are run and evaluated on key performance indicators (KPIs), like average handle time, cost of service or others, but customers don't care about the company's optimized costs, they're more concerned about whether they experienced empathy, attentiveness, and a resolution on their call. None of those components are absolute either. For example, if someone wants to return a broken product, and you give them their money back but are rude about it—you've resolved their issue, but they probably aren't going to buy from you again. So, we built CloudCherry to help companies understand where to invest to improve the customer journey, and we raised funding from corporate and venture investors along the way.

Cisco was one of our investors, since they agreed with our hypothesis that the contact center is really a customer experience business. And so when we began receiving unsolicited acquisition offers from other companies in the space, they made an offer as well. There's a lot that goes into evaluating an acquisition offer. Obviously there's the price, but the terms are very important as well—is it cash or stock? What's the vesting period? Are there clawbacks, performance riders, or other contingencies? In addition, evaluating the company's "acquisition muscle" — their experience and reputation for successfully completing the process and integrating acquired firms is important, too. If you enter exclusivity with one firm and they decide to abandon the deal, it sends a negative signal to all of the others that may make it harder to get acquired in the future.

Ultimately, given all of these considerations and our long relationship with the company, we chose to be acquired by Cisco. That decision was validated by my experience there. The majority of our team joined Cisco and the company put in a lot of work to make sure our culture was safeguarded. For example, at CloudCherry we had an inspiration wall, where each new employee who joined put up a picture of something that inspired them—Cisco let us replicate it there despite the scale it would have to become. They plotted the closest office location to each employee so they wouldn't have to relocate. And we continued to innovate and build our product. For me personally, I ended up becoming Chief Operating Officer for Webex Customer Experience, which was a massive learning experience.

I really enjoyed my time at Cisco—in fact they knew I would never leave to another large company, because if that was the alternative, I'd rather be at Cisco—but my real joy lies in startups. My two options seemed to be: be an investor, which I was already doing, or start a new startup. Ultimately, I decided I wasn't ready to start a new company again (yet), and joined a friends' growth-stage startup, Uniphore, which seems well positioned to IPO one day.

I am also supporting startups as the Co-Chair of the U.S.-India Strategic Partnership Forum. Barriers to immigration is one of the key issues that needs to be solved to bolster the startup ecosystem and both countries' economies. Something like half of unicorn startups have one Indian cofounder, and for every visa awarded to an Indian startup founder, 40 high-paying local jobs are created. Despite this, founders often struggle to come to the U.S. and often end up using job-seeking visas. Such founders are actively being courted by other countries with tailored immigration processes, resources and other incentives. To remain competitive, we need an entrepreneur visa that helps high-skilled individuals who are starting businesses, bringing capital, and creating jobs to do so in the U.S.

Startup Aquisition Experience: PARTPIC

Acquired by Amazon • Atlanta, Georgia
Jewel Burks Solomon, Founder and CEO

Partpic leverages visual recognition technology to help enterprise customers identify industrial parts and save time during maintenance and repairs.

Earlier in my career, I worked in enterprise sales, including for Google and for an industrial parts company, called McMaster-Carr. While at McMaster-Carr, I thought there must be a better way to organize and identify parts using technology—which led me to found Partpic. Users could take a picture of the part they were looking for and Partpic would match it to the correct replacement. We licensed the technology to companies for their websites to help their customers find the parts they needed.

Starting out, we had bootstrapped before raising a seed round. We were actually in the process of trying to raise another round of funding when we were acquired. We were in talks with Amazon about investing in Partpic when the conversation turned into an acquisition offer. It moved too quickly for me to solicit other company acquisition offers, but the investment offers we had coming in helped to raise the acquisition value.

At the time of the acquisition in 2016, we were about four years old and had a team of 15 employees. All but one joined Amazon after the acquisition as part of the Amazon visual search team in Atlanta. Our team was responsible for integrating and building what became Amazon Part Finder, which was released in 2018, about 18 months after we were acquired. I stayed at Amazon for three years—some of our team is still there, but they have all gone to work on different projects.

The integration process with Amazon was tough. Perhaps it was the transition from being a nimble startup to part of a large enterprise or other corporate culture issues, but we really struggled to get the resources we needed to be successful and launch Part Finder. The executive who was our champion within Amazon left about 9 months after we were acquired, which probably compounded the issues. Post-acquisition integration is really important for acquiring companies to get right for startup founders and their employees to have positive experiences and be successful.

From the outset, I always thought that the exit path for us would be via acquisition, given our product and strategy. However, I think we still had room to grow the company further at the point we actually sold. The biggest impediment for us was access to capital—we were having difficulty with fundraising at the time, and a lot of bias in the system contributed to that. Helping to combat these issues motivates the work I do with underrepresented founders at Collab Capital and Google for Startups. Founders should be able to pursue the pathway to exit that is right for them—whether that be an IPO or being acquired—without facing the biases and burdens that can constrain the choices available to them and their potential for success.

Ultimately, the acquisition gave me an authoritative perspective on the entire startup journey from ideation to successful exit. For the work that I do now at Google for Startups and Collab Capital, I'm able to help startups in a different way because I've experienced every part of the journey. That has allowed me to support startup leaders, especially by equipping founders thinking about selling their startups with the many things I did not know going into the process myself.

Startup Aquisition Experience: **NEPRIS**

Acquired by Providence Strategic Growth Fund (PSG Equity) • Austin, Texas
Sabari Raja, Cofounder & CEO

Nepris is an education technology platform that enables educators to connect their students with industry professionals to bring real world relevance and career exposure to every student. Through Nepris employers have an opportunity to engage their current workforce with the future workforce, helping bridge the workforce pipeline gap.

I went to school in India before moving to the U.S. and earning a Master's degree here. Out of school, I went to work for Texas Instruments in their education technology group. Ed tech at the time was very nascent. Working in the space, I got firsthand insight into how technology can impact students' learning and bring equity of access in education. It became evident to me that stakeholders in education, government, nonprofits, and companies were doing a lot to bridge the workforce pipeline gap, but they weren't really leveraging technology to expose students to experiences outside of their immediate network—which especially impacts girls, rural, and minority students. We thought that someone should be making the connection between industry and students earlier—when first graders are learning about rocks, connect them to a geologist, for example—rather than once they're about to look for jobs. That's the basic idea that led my cofounder and I to build Nepris.

We raised two seed rounds before raising our Series A in 2020. While COVID presented challenges, it also presented a lot of opportunities for us. Things were going well—we had plenty of runway, were near profitability, and were growing at 100 percent year over year. But the edtech space had grown up, too—rather than being something niche there were now dozens of competitors to keep pace with. We thought that acquisitions might be a way to accelerate our growth. That wasn't something we were equipped to do as founders, so we ran a process with Vista Point Advisors, through which we had our choice of private equity firms and ended up choosing Providence Strategic Growth Fund (PSG).

As first-time entrepreneurs, we initially had a very stereotypical view of PE—PE buys failing companies and picks them apart, so you don't want to be acquired by PE, you want a strategic buyer, we thought. After talking with founders that had been through the process, we realized that the right PE firm actually might be a better fit for us. With a strategic buyer, you have to slot in that company's products somewhere, you might be locked in for a time, and how well the integration process goes—both cultural and technical—really depends on the company. While we had interest from strategic buyers and PE firms, for our goals of continued growth, a PE buyer that had experience and a good playbook for growth through acquisitions seemed like a better fit. For us, that was PSG. And they had recently acquired a company called Virtual Job Shadow whose strengths paired really well with ours. We merged with Virtual Job Shadow earlier this year and became Pathful. I've since transitioned my duties to a new CEO and become a board member and Chief Strategy Officer where I coordinate our growth strategy.

As you found a company, you have pretty realistic expectations—you know not every company is headed down the IPO path. Overall, very few education technology companies are public companies. Going from one to five million dollars in revenue was tough. Going from five to 10 million was even tougher. Taking it from 10 to 100 million—at minimum where you need to be to think about IPO—is a completely different ballgame. And unlike the early stages where it's exciting and you're innovating everyday, it is very operational. A lot of founders aren't suited to that challenge, get fatigued, or both. So for most founders, growth through acquisition is the realistic and feasible path.

One thing that is really helpful to the startup ecosystem is Qualified Small Business Stock tax treatment (QSBS)—and so few people know about it. I didn't learn about it until we were going through the acquisition process. Then the Build Back Better bill came out with retroactive changes to QSBS that meant we would've missed the favorable treatment by two weeks. Thankfully those changes did not pass, and with the tax savings as a result of QSBS, I was able to invest in six seed-stage startups just this year. Angel investors are really important for early-stage funding and QSBS plays a big role in keeping capital in the ecosystem and helping angels fund more companies to grow the ecosystem. I am excited that I have the opportunity now to continue paying it forward in supporting early stage entrepreneurs.

Startup Aquisition Experience: 21LABS

Acquired by Perforce Software • Campbell, California
Shani Shoham, CEO

21Labs is an autonomous testing and analytics platform that lets mobile app developers and engineering teams accelerate their release cycle and perfect the user experience for Android and iOS applications.

Throughout my career, I have worked for and founded various technology companies and venture capital funds. One company I worked for provided the infrastructure for test automation, but you still needed engineers to write the scripts and manage them. That led to low test coverage and increased cost of testing. Using the knowledge I had gained and what I saw as a gap in the market, I started 21 Labs to further automate the process of UI testing and functional testing of mobile applications.

We integrated and partnered with companies like Perforce, Sauce Labs and others to provide the infrastructure to our customers. These partners also reached out to us for joint GTM activities and introduced us to their customers. It made the acquisition the next step in the natural progression.

I stayed at Perforce to help with integration, but once that was settled and my contractual obligations were up, it was time for me to move on to the next thing. Earlier this year I left Perforce to become the Chief Revenue Officer at a new startup that is focused on software development, testing, demo and deployment environments to help speed software release cycles.

The acquisition of 21 by Perforce was a success and the right move for us, and I hope policymakers don't make these sorts of transactions more difficult. However, one issue that we ran into with 21 is talent. There simply is not enough skilled labor—developers—to be able to recruit and retain the talent we need. As a startup, we couldn't really compete with the compensation packages that large established companies were offering, especially in the Bay Area. While we would have loved to help build the local economy through employment too, we ended up relying on developers from Eastern Europe to grow 21. Part of the answer to this talent problem has to be making it easier for immigrants to come to the U.S.

EXITS AND TALENT

Talent—knowledge and experience—is at least as essential to startup success as the capital needed to seed and grow companies. And critical talent includes the startup founder, with her vision and experiences; expertise and perspective they hire or bring on through cofounders and early employees; and mentors, advisors, and board members that help guide the company. The role know-how and prior experience plays in startup success is not to be understated—new companies with outside mentors succeed at twice the rate of those without.[28] Many such mentors have lived the full range of the startup experience—from launch to raising capital to scaling to exit, sometimes several times over.

Startup exits play a critical role in the development and mobility of talent through the startup ecosystem. If individuals remain at one firm their entire career, dynamic benefits to the economy—leveraging their experiences to grow new ventures—won't accrue and ecosystem building becomes harder. In this way, exits via acquisition are particularly important since key talent are more likely to remain at a company after an IPO (rather than start or join a new company) and likely to seek the certainty of salaried income (sometimes outside the startup ecosystem) following failure and shutdown.[29]

When a startup is acquired, its employees almost always initially stay on at the acquiring firm.[30] Indeed, the startup's key talent—founders, engineers, and those in other leadership roles—are often subject to vesting periods (if paid in stock) or other contract terms that require them to stay at the company for a certain period of time, usually anywhere from six months to three years. During this time, they help integrate the startup's technology into the acquiring firm and experience new processes around running a large enterprise. And working at the acquiring firm can be "a welcome break from the nonstop pace of running a startup," as one acquired founder told us.

At some point following that breather, the cycle begins anew. Founders usually leave the large company and join or launch new startups[31]—critically, taking the knowledge and experience with them. The prior exit experience is looked upon favorably by investors—who see both a founder with a demonstrated ability to scale and a likely eventual positive return on their investment—helping repeat founders to raise capital for their new ventures. And it is needed to help new entrepreneurs succeed. As one founder put it, "we need more people that have done this before" to help develop the ecosystem. Cycles of talent helps the local startup ecosystem to grow,[32] advances innovation, and creates quality jobs—positive outcomes in which the exit via acquisition was a crucial component.

However, some policymakers worry about the role of acquisitions and talent—especially when startups are acquired principally for their teams rather than their technology—colloquially called 'acquihires.'[33] Concerns about these transactions generally fall into two categories: their competitive effects and the impact on the availability of talent. Both are misguided. In most cases, such exits are the best option for the startup, which has tried, but was unable to raise additional capital.[34] Rather than being anticompetitive, the acquisition offers the startup's founders and employees a soft landing (and, as discussed, launching pad for their next act). Indeed, one founder of an AI startup "acquihired" (along with their entire team) by Google called the exit "the right decision for us." The founder has since left to join a new startup as an executive. And empirical research shows that talent brought on by acquisition leaves (to young small firms, i.e., startups) at much higher rates than their conventionally hired counterparts.[35] Acquisitions, then, help, rather than harm, economic dynamism.

WHAT WE CAN LEARN FROM IPO REGIMES ABROAD

Acquisitions play a critical role in the startup ecosystem—particularly in places outside of the largest hubs—as shown through both the data and firsthand experiences of startup founders in this report. However, some policymakers are considering changes that would impede founders' ability to sell their companies or even prohibit acquisitions of startups altogether. They envision that companies will merely go public instead,[36] which risks harming the startup ecosystem and startups' ability to innovate and earn investment.

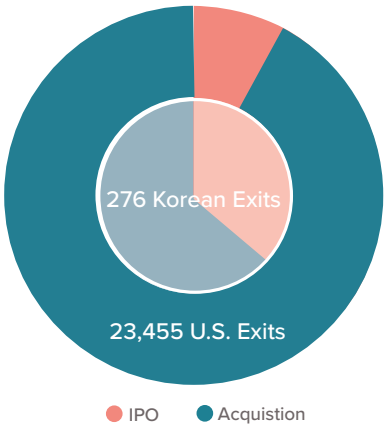
To further underscore the importance of acquisition activity in healthy startup ecosystems, this section leverages cultural, legal, and structural differences found abroad that lead those countries to rely more heavily on IPOs. Both South Korea and Australia have few large acquirers, like those that exist in the U.S., and have systems that allow companies to go public "early" at a low market capitalization. These early IPOs are not exits in the traditional sense, if at all—they are often fundraising events where existing shareholders (like founders, employees, and investors) are subject to long lock-up periods, and market dynamics make it difficult for them to get liquid. As a result, capital and talent don't cycle through the ecosystems there. The countries' experiences highlight the importance of acquisitions to dynamic, healthy startup ecosystems, and the folly of standing up early IPO regimes as a perfect alternative to healthy acquisition activity.

South Korea

Cultural and market factors make South Korea a somewhat insulated market with little acquisition activity, which makes it a useful case study on the importance of exits to startup investment and ecosystem growth. While there are still more exits via acquisitions than IPOs on the whole, acquisitions are not popular in the country. In addition to regulatory headwinds,[37] Korean entrepreneurs regard their companies "like family" and avoid selling, especially to large companies—which would be akin to "selling your soul," as one Korean investor indicated to us. In addition, many Korean software companies sell to consumers or government, and usually remain national, rather than scaling globally—both limiting growth and potential desirability to foreign would-be acquirers. For investors (and founders), this makes it difficult to exit or get liquid.

In part to solve liquidity issues, the government has created an early IPO process. The startup and small-entity oriented stock exchange in Korea is the KOSDAQ (Korean Securities Dealers Automated Quotations), formed in the late 1990s.[38] In the mid 2010s, listing rules were relaxed to allow a special exemption for technology companies to IPO on the exchange. To qualify, companies must meet certain technology requirements but are exempted from some typical revenue and profit requirements required by the exchanges. The technology requirements meant that software companies were not able to use the exemption—but biotechnology companies were. In mid-2019 the exemption was expanded to allow software companies to undergo early IPOs as well.[39]

Share of Exits by type, 2011-2021



The difference in potential exit opportunities between software and biotechnology startups is reflected in investment—Korean venture investors are likely to invest 50 to 100 times more in biotechnology startups than in software startups. And the overall lack of opportunities to exit leads some investors to seek other methods of getting liquid. For example, investors may sell their shares to other investors (or back to the founder, in the worst case), usually for a loss. If an investor holds redeemable shares, which trigger a sale at a certain return

(usually two and a half to five percent), they can earn a very low return—but this too is regarded as failure from an investor perspective. Share structures (and lack of acquisitions) further limit the ability of investors to force an exit event to recoup their investment or earn a return.

While the early IPO process is designed to fix some of these issues with liquidity and provide technology startups with access to the public markets, performance is poor and plagued with practical issues. In an early IPO, companies aren't generally able to raise much capital to fuel additional growth—usually just 10 to 20 percent of their valuation. Investors, founders and other existing shareholders are subject to lock-up periods where they are unable to sell their shares for a certain period of time following the IPO. In some cases, for the largest shareholder (usually the founder), this period is one year. The long lag does disincent insiders from overhyping the stock, but often investors sell their shares right away after they are permitted to do so regardless, with predictable results.[40] The share price drops significantly and is unlikely to ever recover—especially since (as a result of the early IPO process) there is no institution (such as an investment bank) analyzing and recommending the stock to their clients.

Expectedly, performance of early IPO companies in South Korea is generally poor, with share prices falling once investors realize the company cannot stand on the fundamentals—an analysis of Korean IPOs from 2013 to 2021 showed that stocks with opening share prices that were 95 percent higher than their IPO prices fell by 44 percent a year later.[41] This should spell a cautionary tale for policymakers envisioning that an early IPO system could replace a vibrant merger and acquisition market without consequences for startup investment.

Australia

Australia has a few distinct characteristics that make it instructive for investment and the startup ecosystem. The country has few large domestic potential acquirers, its stock exchange rules allow early stage companies to list on their stock exchange ASX (though they have been tightened in recent years) and it has few large domestic VC firms capable of writing late-stage growth checks (series B, C, D+).

Beyond consequences for investment, the lack of several large domestic acquirers in Australia stymies the flow of talent and knowledge-building in the ecosystem there. And both factors create headwinds for overall ecosystem growth. In Australia, Atlassian is the predominant large potential acquirer, but Australian startups are also frequently acquired by large (mostly American) foreign companies. This disrupts typical cycles of talent in the ecosystem because key employees are dispersed, potentially overseas, or might not join the acquiring firm. Domestic acquisitions, where employees remain in the ecosystem, by contrast, enable important talent development. Employees of the acquired startup learn systems and processes at the acquiring firm and hone skills necessary for running and growing large enterprises. When they leave to launch new startups or invest in and advise fellow entrepreneurs, they bring those skills and experiences with them.

Though it has grown meaningfully over the past decade, the VC industry in Australia historically has not been large enough to fund lots of growth-and late-stage startups. Though some particularly successful Australian startups could (and still do) draw interest and investment from U.S. and European VCs, Australian startups often go public sooner and at lower valuations than American startups.

Australian startups going public early is not an exit—rather, it is to raise additional capital. The amount raised is historically comparable to raising series A, though now more comparable to series B or C, both as VC availability has improved and listing requirements have been tightened.[42]

Even if founders or investors wanted to take money off the table after going public, it would be very difficult and not without consequence. Company insiders are subject to long lock-up periods where they cannot sell shares,

sometimes two years—this is an investor protection that is designed to disincent overhyping the company's stock price.[43] And when they are able to sell, trying to sell down their stock holdings sends a signal to public investors who are left wondering if you know something they do not, and why you're taking money meant for growth off the table.

Regardless of location, being a public company invites compliance costs and investor scrutiny, but when startups go public before they reasonably should, as in Australia in the early 2010s, it invites additional headwinds. Listing without deep institutional backing, e.g., of an investment bank, means their analysts aren't scrutinizing your stock and recommending it to their clients. And being public as an early or growth stage startup means you don't control your share price. Since public, retail investors do not know how to value startups, startup valuations can become dislocated from where experienced startup investors would value the company. This can make it difficult to raise additional capital needed to keep growing, and the startup with once-great potential becomes a zombie with enough resources to keep existing but few options to raise capital needed to grow.

Companies that have IPOed early in Australia have generally performed poorly (this is true in the U.S. context as well)[44] and have experienced large swings in valuation—with one enterprise software startup's share price going from a few cents to $2 back to a few cents.[45] To counteract this, the ASX has tightened the exchanges listing rules.[46] Taken together, the comparative experience of the Australian and U.S. startup ecosystems highlights the important role of acquisitions—as an exit path, for promoting investment, for recycling talent—in a healthy vibrant startup ecosystem.

IMPLICATIONS FOR TODAY'S POLICY DEBATES

This report has walked through the role of exits in the startup ecosystem—the incentives they provide for founders to launch companies and the incentives for investors to fund them; the preeminence of acquisition as an exit path for startups, especially in smaller startup ecosystems; the development and flows of talent in the ecosystem they enable; and the firsthand experiences of startup founders that have had their companies acquired. Each of these factors has bearing on today's burning policy debates about competition in the technology sector, particularly those around the role of startup acquisitions. Policy proposals by agencies and in Congress alike threaten to lessen the availability of acquisition as an exit path for startups.

Startups care about acquisitions as an exit path because it helps them to raise capital for investors—and helps reduce the risk of starting a company. IPO is another exit path that many entrepreneurs hope for, but they know it is not an interchangeable alternative with acquisition—different factors lead up to each type of exit. And going public early can go poorly, whether considering the experiences of early IPO systems found abroad or those that go public at low values in the U.S. As a result, IPO doesn't meaningfully offer to 'fill the gap' if the availability of being acquired is indeed reduced through policy change or chilled by enforcement actions based on novel legal theories.[47]

No one is in favor of anticompetitive conduct, least of all startups, who can be particularly vulnerable as small entities with generally few resources. But arbitrary policies that either target only a few large firms based on size or sow uncertainty to broadly discourage acquisition activity threaten to run counter to their stated goals of helping startups.

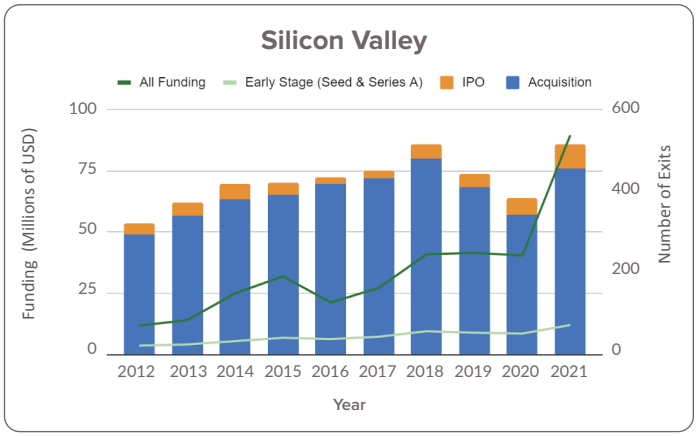
For example, bills introduced in both chambers of Congress would target around five large technology companies, based on market capitalization and other metrics, with the goal of preventing them from acquiring startups.[48] Disallowing some companies (and disincenting others) from acquiring startups takes would-be acquirers off the table, leading to lower acquisition prices and reduces incentives to invest in startups. This has been shown in studies of the bills: they would both reduce investment—by over 12 percent—and reduce exit values—by over 21 percent.[49] Indeed, as one founder who had their company acquired told us: "we had a few other offers from later-stage startups, and I think them knowing Google was at the table really helped," but in the end, "Google's offer was the highest, and it made the most sense for us."

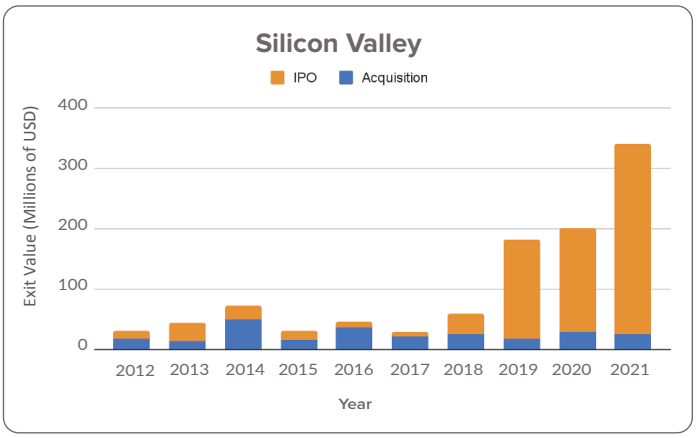
The bills would exempt smaller deals under $50 million from the restrictions imposed on mergers and acquisitions,[50] but this too is arbitrary. While most acquisitions are indeed for amounts below $50 million, exempting those deals could create incentives to acquire companies earlier. For those worried about acquisitions of startups in themselves stifling potential competition, exempting small deals would appear to have the opposite of the stated intent.

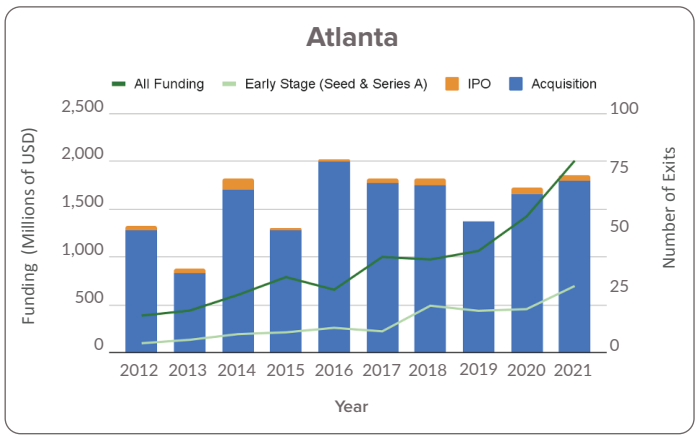
Instead, precise enforcement and individualized scrutiny based on clear, communicated principles is a better approach for the startup ecosystem. Such an approach can ensure that remedies are tailored and do not inflict harms to competition that would outweigh benefits from actions addressing the problematic conduct.

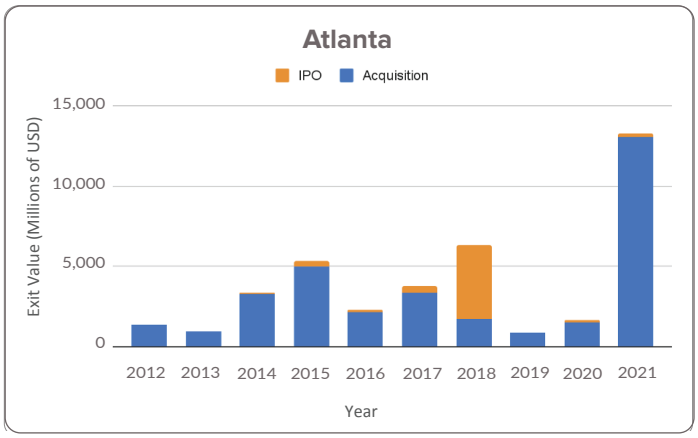
To help startups compete, policymakers can start by addressing their everyday needs. Engine publishes a weekly profile of a startup founder from across the U.S. discussing the policy issues impacting them, and founders routinely bring up a number of ways that policymakers could reduce the obstacles they face.[51] To increase the availability of investment, policymakers can enact reforms that increase the pool of potential startup investors and ensure that government grants and resources are available to early-stage startups.[52] To reduce the costs of critical talent needed to grow startups, policymakers can enact immigration reforms and invest in STEM education to increase the talent pool in the U.S.[53] To mitigate the costs of scaling nationally, policymakers should enact a single federal standard for privacy and work to reduce complex tax burdens.[54] To mitigate meritless litigation, policymakers should take steps to ensure patent quality and defend intermediary liability limitations.[55] Rather than break the investment model that has led to the development and growth of the startup ecosystem, policymakers should start here, because for startups, all policy is competition policy.

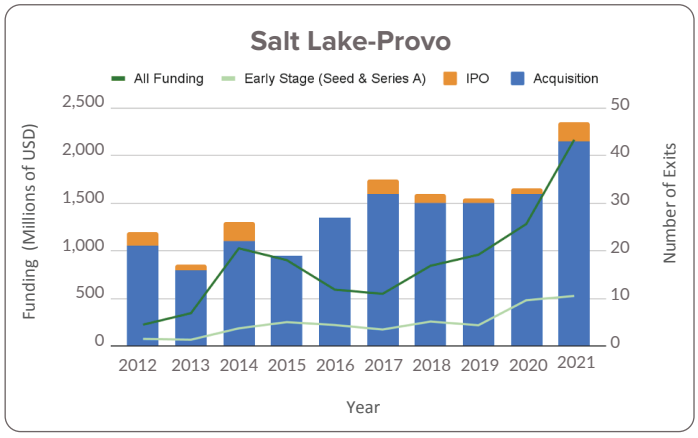
APPENDIX

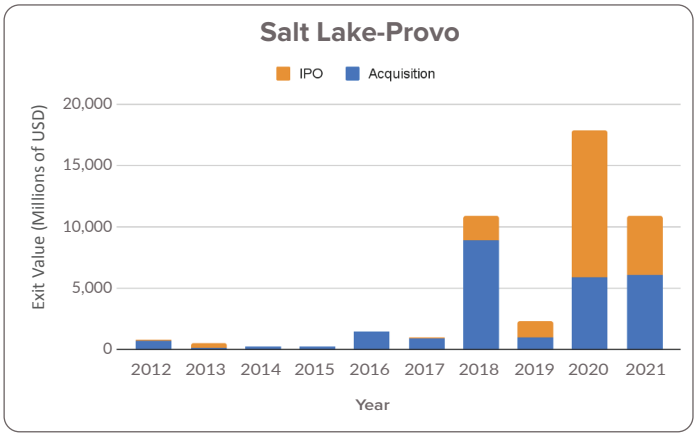

Silicon Valley
All Funding
Early Stage (Seed & Series A)
IPO
Acquisition
Funding (Millions of USD)
Number of Exits
Year

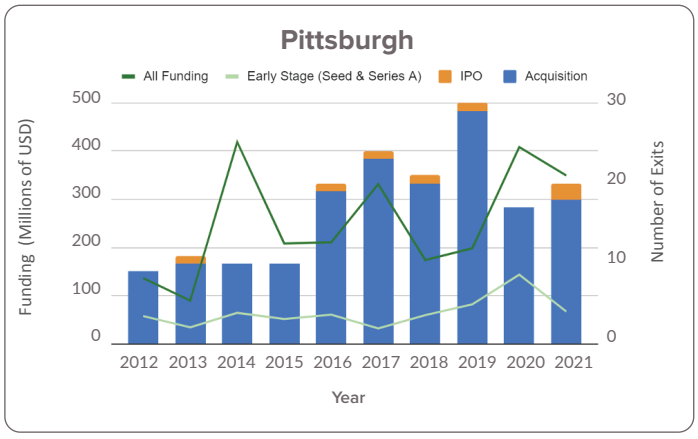

Silicon Valley
IPO
Acquisition
Exit Value (Millions of USD)
Year

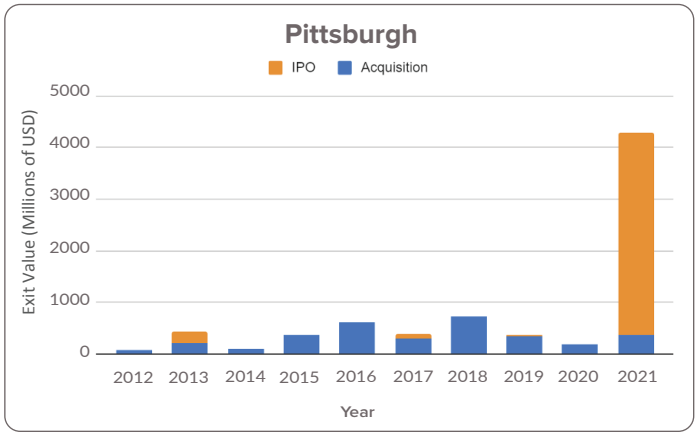

Atlanta
All Funding
Early Stage (Seed & Series A)
IPO
Acquisition
Funding (Millions of USD)
Number of Exits
Year


Atlanta
IPO
Acquisition
Exit Value (Millions of USD)
Year

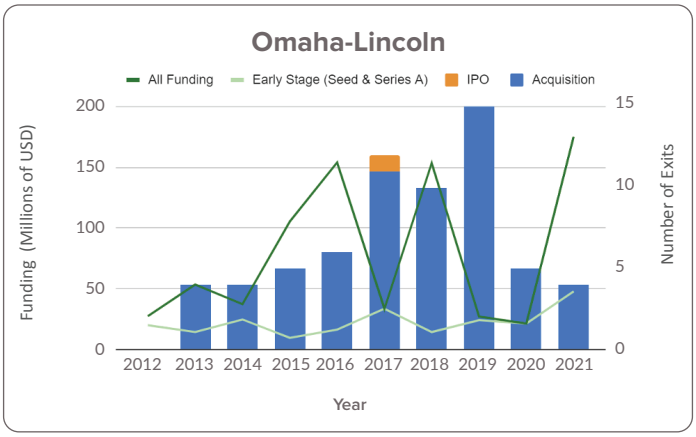

Salt Lake-Provo
All Funding
Early Stage (Seed & Series A)
IPO
Acquisition
Funding (Millions of USD)
Number of Exits
Year

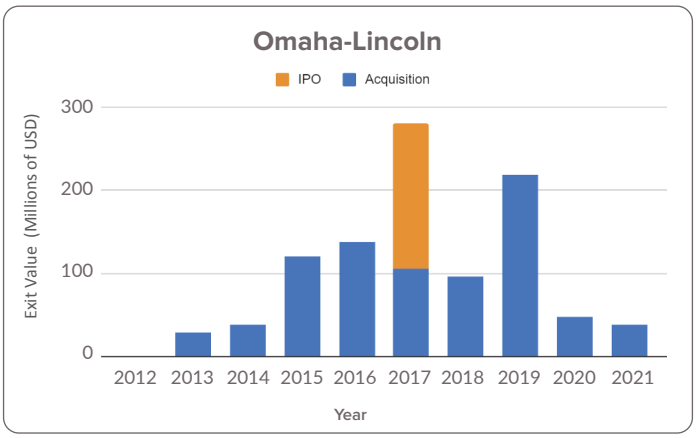

Salt Lake-Provo
IPO
Acquisition
Exit Value (Millions of USD)
Year

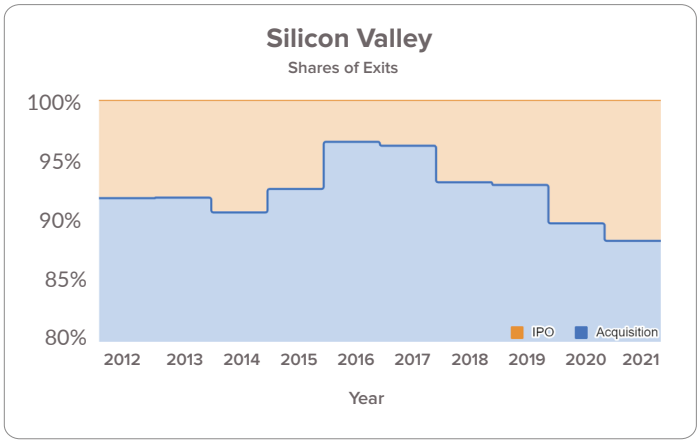

Pittsburgh
All Funding
Early Stage (Seed & Series A)
IPO
Acquisition
Funding (Millions of USD)
Number of Exits
Year

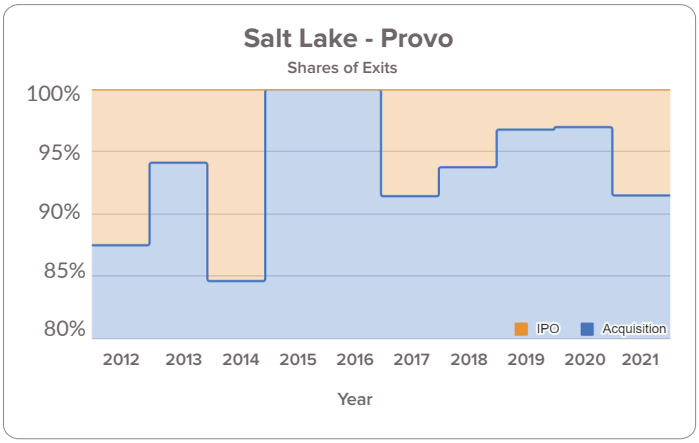

Pittsburgh
IPO
Acquisition
Exit Value (Millions of USD)
Year

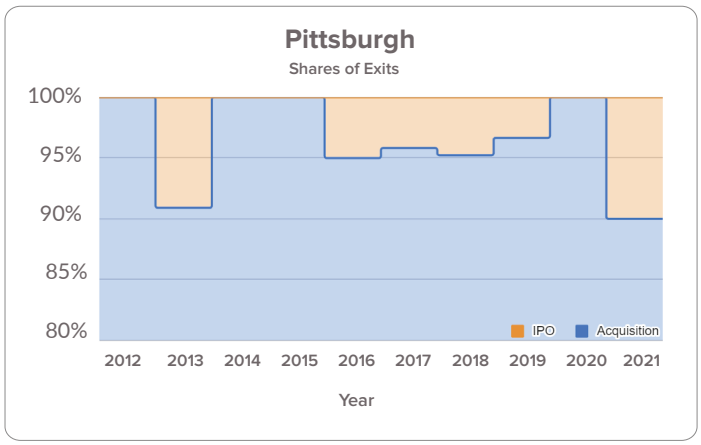
APPENDIX

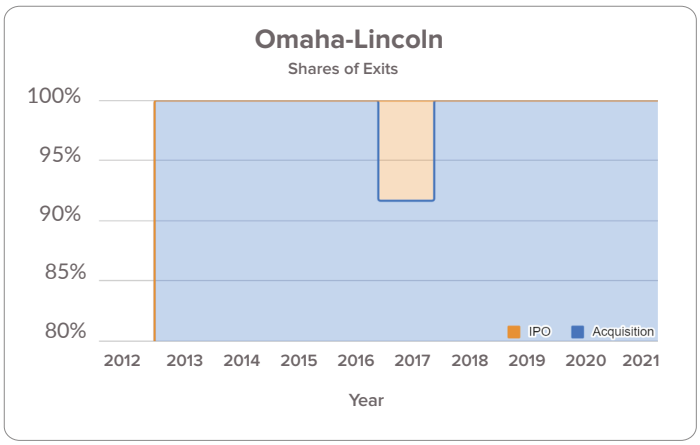

Omaha-Lincoln
All Funding
Early Stage (Seed & Series A)
IPO
Acquisition
Funding (Millions of USD)
Number of Exits
200
150
100
50
0
15
10
5
0
2012 2013 2014 2015 2016 2017 2018 2019 2020 2021
Year

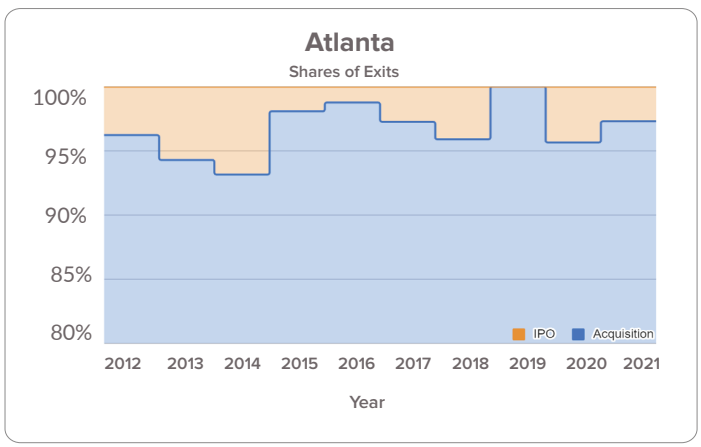

Omaha-Lincoln
IPO
Acquisition
Exit Value (Millions of USD)
300
200
100
0
2012 2013 2014 2015 2016 2017 2018 2019 2020 2021
Year


Silicon Valley
Shares of Exits
100%
95%
90%
85%
80%
IPO
Acquisition
2012 2013 2014 2015 2016 2017 2018 2019 2020 2021
Year


Salt Lake - Provo
Shares of Exits
100%
95%
90%
85%
80%
IPO
Acquisition
2012 2013 2014 2015 2016 2017 2018 2019 2020 2021
Year


Pittsburgh
Shares of Exits
100%
95%
90%
85%
80%
IPO
Acquisition
2012 2013 2014 2015 2016 2017 2018 2019 2020 2021
Year


Omaha-Lincoln
Shares of Exits
100%
95%
90%
85%
80%
IPO
Acquisition
2012 2013 2014 2015 2016 2017 2018 2019 2020 2021
Year


Atlanta
Shares of Exits
100%
95%
90%
85%
80%
IPO
Acquisition
2012 2013 2014 2015 2016 2017 2018 2019 2020 2021
Year

ENDNOTES

1. *See, e.g.*, Justin Kahl and David George, *A Framework for Navigating Down Markets*, a16z (May 13, 2022), https://future.a16z.com/framework-valuation-navigating-down-markets/; *The upside of a downturn*, Lightspeed Venture Partners (May 16, 2022), https://medium.com/lightspeed-venture-partners/the-upside-of-a-downturn-9219ea4b26a2.
2. *See, e.g.*, *Consumer Price Index for All Urban Consumers: All Items in U.S. City Average and Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average*, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/graph/?g=8dGq.
3. *See The State of the Startup Ecosystem*, Engine 6 (Apr. 2021), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/60819983b7f8be1a2a99972d/1619106194054/The+State+of+the+Startup+Ecosystem.pdf (for data and discussion of 2016 "saas valuations crisis").
4. Susan Woodward, *Irreplaceable Acquisitions*, Sand Hill Econometrics 5-6 (Nov. 2021), http://www.sandhillecon.com/pdf/Woodward_Irreplaceable_Acquisitions.pdf.
5. *Id.*
6. *See 2020 Startup Outlook Report*, Silicon Valley Bank 5 (2020), https://www.svb.com/globalassets/library/uploadedfiles/content/trends_and_insights/reports/startup_outlook_repor t/suo_global_report_2020-final.pdf; *2019 Startup Outlook Report*, Silicon Valley Bank 7 (2019), https://www.svb.com/globalassets/library/uploadedfiles/content/trends_and_insights/reports/startup_outlook_report/us/svb-suo-us-report-2019.pdf.
7. *See Startup Outlook, supra* note 6; *see also Startup Ecosystem, supra* note 3 (noting that these figures do not include startups that end in failure).
8. *See, e.g.*, *The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance: Hearing before the Subcommittee on Investor Protection, Entrepreneurship and Capital Markets* 115th Congress (2017) (Remarks of Chairman Huizenga), https://www.govinfo.gov/content/pkg/CHRG-115hhrg28750/html/CHRG-115hhrg28750.htm.
9. *See Startup Ecosystem*, *supra* note 3
10. *See Irreplaceable Acquisitions, supra* note 4, at 5.
11. *2020 Startup Outlook Report*, Silicon Valley Bank 5 (2020), https://www.svb.com/globalassets/library/uploadedfiles/content/trends_and_insights/reports/startup_outlook_report/suo_global_report_2020-final.pdf.
12. *See Irreplaceable Acquisitions, supra* note 4, at 5.
13. Bob Zider, *How Venture Capital Works*, Harv. Bus. Rev. (1998), https://hbr.org/1998/11/how-venture-capital-works#:~:text=They%20expect%20a%20return%20of,have%20a%20lot%20of%20latitude. *See generally* Paul Gompers & Josh Lerner, *The Venture Capital Cycle*, MIT Press (2004). See *Irreplaceable Acquisitions, supra* note 4 for a recent brief discussion of the VC cycle and compensation structure.
14. Paul Gompers & Josh Lerner, *The Venture Capital Revolution,* 15 J. of Econ. Perspectives 145, 146-52 (2001), https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.15.2.145; Josh Lerner & Ramana Nanda, *Venture Capital's Role in Financing Innovation: What We Know and How Much We Still Need to Learn*, 34 J. of Econ. Perspectives 237, 238-39, 245-48 (2020), https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.34.3.237.
15. David Lingelbach & Evan Gilbert, *Toward a Process Model of Venture Capital Emergence: The Case of Botswana* (Aug. 21, 2009), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1459183.
16. As one notable exception, MailChimp was bootstrapped before being acquired by Intuit in 2021 for $12 Billion. See *Intuit Completes Acquisition of Mailchimp,* Intuit (Nov. 1, 2021), https://mailchimp.com/intuit-completes-mailchimp-acquisition/.
17. *See, e.g.*, *How to plan for retirement*, Ameriprise Financial, https://www.ameriprise.com/financial-goals-priorities/retirement/retirement-planning-basics.
18. *See generally Comments of Engine Advocacy in response to Request for Information on Merger Enforcement, Docket no. FTC-2022-0003-0001*, Engine (Apr. 21, 2022), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/626090a94d6c20727e338d01/1650495664536/Merger+Guidelines+RFI+Submission+042122.pdf.
19. *Startup Ecosystem*, *supra* note 3, at 11-12; Tiago Prado & Johannes Bauer, *Big Tech Platform Acquisitions of Start-ups and Venture Capital Funding for Innovation*, 59 Information Economics and Policy 1,3 (2022) https://www.sciencedirect.com/science/article/pii/S0167624522000129#fig0005.

20. *Big Tech*, *supra* note 19.
21. *Startup Ecosystem*, *supra* note 3, at 11-12.
22. *See Irreplaceable Acquisitions, supra* note 4.
23. *See generally supra* Exit Lifecycle: IPO.
24. *Startup Ecosystem*, *supra* note 3, at 9-12; *The Cost of Being a Public Company*, *supra* note 8.
25. *Partial Transcript: Your World with Neil Cavuto*, Fox News (Jul. 30, 2002), https://www.foxnews.com/story/sen-paul-sarbanes-d-md-rep-jeff-flake-r-ariz.
26. *See* 148 Cong. Rec. S7353 (2002) (Remarks of Sen. Gramm) https://www.congress.gov/crec/2002/07/25/CREC-2002-07-25-pt1-PgS7350-4.pdf; *id.* at S7361 (remarks of Sen. Bond).
27. *The Impact of Consolidation and Monopoly Power on American Innovation: Hearing before the Subcommittee on Competition Policy, Antitrust, and Consumer Rights of the Committee on the Judiciary,* 117th Congress (2021) (Testimony of Bettina Hein) https://www.judiciary.senate.gov/meetings/the-impact-of-consolidation-and-monopoly-power-on-american-innovation.
28. *See, e.g.*, Kathleen McShane, *Mentoring: the missing link to small business growth and survival*, Small Business Administration (Feb. 4, 2019), https://www.sba.gov/blog/mentoring-missing-link-small-business-growth-survival#:~:text=A%20survey%20by%20the%20UPS,that%20having%20one%20was%20invaluable; Kushboo Jain, *Why Every Entrepreneur Needs a Mentor*, Entrepreneur (Apr. 14, 2021), https://www.entrepreneur.com/article/369347; *GROWING THE INNOVATION ECONOMY: A Policy Roadmap for Supporting Startups Everywhere*, Engine 2 (2022), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/62fbb0a039956b0d96fef653/1660661921600/Growing+the+Innovation+Economy+Recover+Paper+2022.pdf.
29. In addition to being intuitively true, this was reflected in the conversations we had with founders and investors. And research leveraging large datasets of startup employees and acquisitions shows the *see*, *e.g.*, Weiyi Ng and Toby Stuart, *Acquihired: Retained or Turned Over?* (Oct. 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3461723.
30. *See generally supra* Exits and the Startup Experience (the founders in these stories all worked at the acquiring firm, for varying lengths of time).
31. This was the case with most of the founders we spoke with. *See also, Acquihired*, *supra* note 29.
32. *See, e.g.*, *Global Startup Ecosystem Report*, Startup Genome (2022), https://startupgenome.com/article/methodology-2022, (especially discussion of talent and ecosystem growth metrics).
33. *Prepared Remarks of Comm'r Rohit Chopra*, Federal Trade Commission (Sept. 15, 2022), https://www.ftc.gov/system/files/documents/public_statements/1596340/20210915_final_chopra_remarks_non-hsr_reported_acquisitions_by_big_tech_platforms.pdf.
34. *See Irreplaceable Acquisitions*, *supra* note 4, at 6.
35. *Acquihired*, *supra* note 29.
36. *Comments of Engine Advocacy*, *supra* note 18; *The Impact of Consolidation*, *supra* note 27 (remarks of Sen. Klobuchar); *The Impact of Consolidation*, *supra* note 25, (remarks of Sen. Durbin).
37. Kim So-Hyun, *M&As slow in Korea due to tight regulations: FKI*, Korea Herald (Feb. 10, 2022), https://www.koreaherald.com/view.php?ud=20220210000704.
38. *See, e.g.*, Mi Eun Roh & Heesug Chung, *The Initial Public Offerings Law Review: South Korea*, The Law Reviews (2022), https://thelawreviews.co.uk/title/the-initial-public-offerings-law-review/south-korea#footnote-000-backlink.
39. Jeong Seung-Hwan, *The door to the wider 'special listing'... Opportunities for investors looking for growth*, Maeil Economic Daily (July 16, 2019), https://www.mk.co.kr/news/stock/view/2019/07/529048/, (translated from Korean).
40. *See generally* Kim Geum-yi & Susan Lee, *IPO darlings in Korea perform poorly, boding badly for this year's pipeline*, Pulse (Mar. 3, 2022).
41. *IPO darlings in Korea perform poorly*, *supra* note 40.
42. *See, e.g.*, *Global Startup Ecosystem Report*, Startup Genome (2022), https://startupgenome.com/article/oceania-insights-rankings-and-ecosystem-pages; *see, e.g.*, *Understanding The Financial Health Of Early Stage Tech Startups*, Alliance Software (2017), https://www.alliancesoftware.com.au/early-stage-tech-startups/.
43. *See, e.g.*, *Post-IPO lock-up: Protecting Australian investors at the risk of global competitiveness*, McCollough Robertson (May 12, 2021) https://www.mccullough.com.au/2021/05/12/post-ipo-lock-up-protecting-australian-investors-at-the-risk-of-global-competitiveness-mccullough-robertson/.
44. *Irreplaceable Acquisitions*, *supra* note 4, at 7-8.
45. *See Early Stage Tech Startups*, *supra* note 42.
46. *Id*.

47. *Comments of Engine Advocacy*, *supra* note 18; *see also, e.g.*, Gary Shapiro, *I lead the Consumer Technology Association and I've never commented on an FTC lawsuit until now. Lina Khan's new case against Meta is laughable,* Fortune (Aug. 3, 2022), https://fortune.com/2022/08/03/consumer-tech-cta-ftc-lawsuit-lina-khan-case-v-meta-acquisition-gary-shapiro/.
48. Platform Competition and Opportunity Act of 2021, H.R. 3826, 117th Congress (2021); Platform Competition and Opportunity Act of 2021, S. 3197, 117th Congress (2021). Some economists and entrepreneurs have additionally argued that other competition proposals, such as H.R.3816 / S.2992, the American Innovation and Choice Online Act, and H.R. 3825, the Ending Platform Monopolies Act would also reduce incentives for covered entities to acquire startups, thereby similarly reducing investment: see, for example, *Irreplaceable Acquisitions*, *supra* note 4 at 1-2; Geoffrey Manne, *How Tech Startups Could Be a Casualty of the War on Self-Preferencing*, Truth on the Market (June 3, 2022), https://truthonthemarket.com/2022/06/03/how-tech-startups-could-be-a-casualty-of-the-war-on-self-preferencing/; Donald Boone, *New "Big Tech" Regulations Could Crush Startups*, Washington State Wire (Aug. 16, 2021), https://washingtonstatewire.com/new-big-tech-regulations-could-crush-startups/).
49. Christian Rippon and Matthew Noelle, *The Economic Costs of Regulation of Online Platforms and Marketplaces*, NERA Economic Consulting 48-56 (Mar. 18, 2022), https://research.ccianet.org/reports/economic-costs-regulation-online-platforms-marketplaces/; *see also Irreplaceable Acquisitions*, *supra* note 4, at 1,9-10.
50. *See Platform Competition and Opportunity Act*, *supra* note 48 (the $50 million threshold was added during markup by amendment from Rep. Deborah Ross D-N.C.).
51. *See generally #StartupsEverywhere*, Engine, https://www.engine.is/startupseverywhere.
52. Nathan Lindfors, *Policymakers Should Expand the Pool of Startup Investors, Not Narrow It*, Engine (Mar. 10, 2022), https://engineadvocacyfoundation.medium.com/policymakers-should-expand-the-pool-of-startup-investors-not-narrow-it-b8854a7770f6.
53. *See, e.g.*, *GROWING THE INNOVATION ECONOMY*, *supra* note 28, at 2-7.
54. *See, e.g.*, *Nuts and Bolts of User Privacy*, Engine (July 2019), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/5d76690b20d6a24eb82a6928/1568041228114/The+Nuts+and+Bolts+of+User+Privacy.pdf; Nathan Lindfors, *State Policy Update: Startups need a solution for post-Wayfair sales tax administration*, Engine (June 14, 2022) https://engineadvocacyfoundation.medium.com/state-policy-update-startups-need-a-solution-for-post-wayfair-sales-tax-administration-3b407fbf3038.
55. *See, e.g.*, *Startups & the U.S. Patent System: Prioritizing Quality and Balance to Promote Innovation*, Engine (July 2021) https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/60f8579bae6a2d324b7440a2/1626888093336/Engine+Patent+Quality+Booklet+2021+7.21.pdf; *Startups, Content Moderation, & Section 230*, Engine (Dec. 2021), https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/61b26e51cdb21375a31d312f/1639083602320/Startups%2C+Content+Moderation%2C+and+Section+230+2021.pdf.

Engine was created in 2011 by a collection of startup CEOs, early-stage venture investors, and technology policy experts who believe that innovation and entrepreneurship are driven by small startups, competing in open, competitive markets where they can challenge dominant incumbents. We believe that entrepreneurship and innovation have stood at the core of what helps build great societies and economies, and such entrepreneurship and invention has historically been driven by small startups. Working with our ever-growing network of entrepreneurs, startups, venture capitalists, technologists, and technology policy experts across the United States, Engine ensures that the voice of the startup community is heard by policymakers at all levels of government. When startups speak, policymakers listen.

With more than 100 clients across six continents in 40+ countries to date, Startup Genome is the world-leading research and policy advisory organization for public and private agencies committed to accelerating the success of their startup ecosystem. Our mission and impact are rooted in more than a decade of independent research with data on 1.5 million companies over 250+ cities. Learn how Startup Genome accelerates global startup ecosystems by contacting Adam Bregu at adam@startupgenome.com and on startupgenome.com, LinkedIn, Twitter.

FTC Lawyers Leave at Fastest Rate in Years as Khan Sets New Tone

The Federal Trade Commission's senior attorneys are leaving at a pace not seen in at least two decades, adding to the challenges facing the agency as it pursues expansive rulemaking.

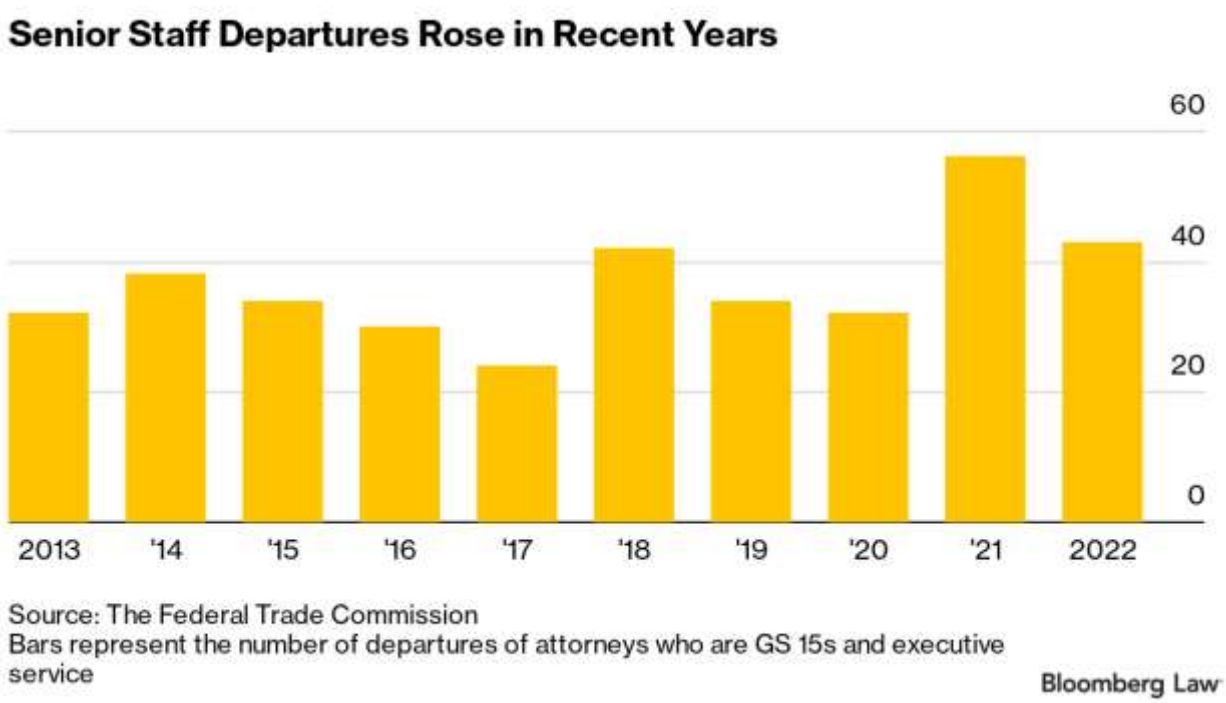
Seventy-one "line staff" attorneys—non-leadership senior attorneys at the top of the federal government pay scale, known as GS-15s—left the agency in the two-year period between 2021 and 2022, according to data obtained by Bloomberg Law under the federal Freedom of Information Act. That's the highest number of departures in the category for a comparable two-year period since 2000.

The wave of departures comes as the FTC undertakes an ambitious rulemaking agenda under Chair Lina Khan, including a proposed ban of employers' noncompete agreements and limiting companies from engaging in "commercial surveillance" and selling or sharing collected consumer data. Khan has aggressively pursued antitrust enforcement, seeking to revive dormant laws in a bid to reign in Big Tech companies.

In total, 99 senior-level career attorneys—including line staff and leadership who are GS-15 and executive service attorneys—left the agency in the two-year period, according to the data. Of the GS-15s who departed, 27 were long-planned retirements, said FTC spokesperson Douglas Farrar.

The FTC, whose missions include antitrust enforcement and consumer protection, employed in total about 750 attorneys as of the end of 2022.

"You lose a lot of institutional knowledge" when senior staff and career leaders leave, said Debbie Feinstein, the former head of the FTC's Bureau of Competition and now a partner at Arnold & Porter. "Career staff know whether something has been looked at before, whether it's been litigated before. And they've been through things that they know is invaluable."



A sizable portion of leadership attorneys—such as deputies and assistant directors of bureaus and specialized offices—also left the agency in 2021. A quarter of the 28 "executive service" employees in leadership departed that year. But three of them were political appointees of the Trump administration, Farrar said.

The departure numbers are the most current tally yet of the FTC's staff retention rates during the Biden administration. The data covers attorney staff and management hires and departures from 2000 through the end of 2022.

The overall FTC attorney departures were significantly higher than average in 2021, but the losses were disproportionately among senior, career staff and leadership employees classified as GS-15s.

"GS-15s are the most experienced staff," said Marian Bruno, a former deputy director of the Bureau of Competition. "Many have professional degrees and years of experience prior to coming to the agency."

The number of staff attorney departures fell in 2022, compared to 2021. The agency also ramped up hiring in 2022, the data show.

"In fiscal year 2021 and 2022 the FTC reviewed and analyzed over 6000 HSR transactions, and brought 49 merger enforcement actions many of which led to abandoned deals," Farrar said, referring to the Hart-Scott-Rodino merger notification program.

"In that same time frame the FTC has proposed rules to ban noncompete clauses and protect American's digital privacy, filed 47 cases and proposed 84 orders to protect American consumers from deceptive advertising and exploitative data practices, and issued 11 policy statements, which is more than double the number of policy statements in any comparable period going back to 2000."

"This volume of activity speaks to the diligence and commitment of FTC staff despite significant resource constraints," Farrar added.

‘Lots of Knowledge’

A certain level of turnover is normal at the FTC, especially in the months after a new chair is confirmed early in a presidential administration. Planned retirements contribute to the departure numbers. And the agency has increased its staff of attorneys by about 200 in the last two decades.

The chaos of the Covid-19 pandemic and the Great Resignation in 2021 also likely contributed to some staff departures.

But the disproportionate spike in departures, particularly in leadership, is unusual, even if not catastrophic, said Daniel Kaufman, who served as Bureau of Consumer Protection deputy director for nearly a decade until October 2021.

Despite added hiring, the agency’s loss of institutional memory could prove a long-term problem as it grapples with heavier workloads and more intensive merger reviews.

“When you have an agency with this broad jurisdiction and you lose people who have been at agency for years with lots of knowledge—the experts—that’s a loss for the agency in terms of substantive expertise and also because the agency focuses on positive management: managerial expertise with people who understand how to get things done,” said Kaufman, now a BakerHostetler partner.

The FTC—working with the Justice Department’s antitrust division—is also undertaking a major overhaul of the merger guidelines, which outline how the regulators analyze and address deals for their anticompetitive impact.

“With this much change—the guidelines and the like—it’s helpful to have people who went through prior guideline revisions and those sorts of things,” Feinstein said.

Political Thunderclouds

Critics of the FTC’s Democratic majority have also raised concerns about staff departure.

“Rampant dissatisfaction among staff has led to the departures of many experienced personnel, causing a notable ‘brain drain,’” departing Republican Commissioner Christine Wilson said in her resignation letter March 2.

She also highlighted a 2022 employee viewpoint survey, which showed that just under half of FTC employees believe their senior leaders maintain high standards of honesty and integrity. That’s down from 87% in 2020 under previous Chairman Joseph Simons.

“Chair Khan is extraordinarily proud of the work that FTC staff do every day to further our mission to protect consumers and fair competition,” said FTC Chief of Staff Elizabeth Wilkins in a statement. “She has taken meaningful steps to address concerns raised in the viewpoint survey because she believes that creating a good environment for her hard working FTC colleagues is central to achieving her antitrust agenda.”

“What jumps out at me is that what we’ve been hearing anecdotally appears to be true: that lawyers did leave in the first full year of the Biden administration,” said Douglass Ross, a professor at the University of Washington School of Law and a former antitrust division attorney.

“That supports the argument some observers were making that some staff were leaving in response to leadership changes at the FTC,” Ross said.

https://www.wsj.com/articles/hostile-takeover-fdic-board-rohit-chopra-michael-hsu-jelena-mcwilliams-abuse-power-11639432939

OPINIONCOMMENTARY Follow

A Hostile Takeover of the FDIC

Board members had always respected the agency's independence—until now.

:Williams

30 pm ET

Rohit Chopra, chairman of the Consumer Financial Protection Bureau, speaks at a Senate hearing in Washington, Feb. 14, 2018.

PHOTO: ANDREW HARRER/BLOOMBERG NEWS

The Federal Deposit Insurance Corporation is led by a five-member board, which for decades has delegated day-to-day operations to its chairman, who by statute serves a five-year term. This structure was designed to ensure independence from changing political administrations and has led to a long legacy of collegiality. For 88 years the chairman has controlled the board agenda and worked collaboratively with other board members.

That all changed on Oct. 31, when board member Rohit Chopra presented me with a draft request for information on bank mergers. Two-and-a-half weeks earlier, Mr. Chopra had been sworn in as director of the Consumer Financial Protection Bureau, a position entitling him to a seat on the FDIC board.

The FDIC has long-established processes for working on policy documents, which are initially drafted by career staff with subject-matter expertise and decades of experience. That the

CFPB director would serve the FDIC chairman with a finished document requesting public comment about the FDIC's merger review process and insist on its publication was unprecedented.

Moreover, whoever prepared the document presented by Mr. Chopra didn't understand the FDIC's merger-approval process particularly well. The FDIC staff reviewed the document and found it was filled with omissions, misrepresentations and technical inaccuracies.

In the spirit of collegiality, I expressed to board members my willingness to work with them on a document drafted by the FDIC staff that would better reflect the agency's historical approach and do so on an expedited basis to meet their desired timing.

On Nov. 16, as I was about to board a flight to Switzerland for a meeting of international regulators, I informed board member Michael Hsu, acting comptroller of the currency, that the FDIC staff document would be available to board members no later than Dec. 6. Seventy-five minutes later, the directors sent a joint letter instructing FDIC staff to mark up their original document instead. Agency staff report to me as the CEO, and I have always ensured that board members have access to staff for discussions, briefings and technical expertise. The board members' letter was an attempt to seize control of the FDIC's staff while its chairman was on a nine-hour flight to Europe for official meetings.

At 5 p.m. on Nov. 26—the day after Thanksgiving—a deputy to Mr. Chopra sent an email from his CFPB account to the FDIC board distribution list, purporting to circulate a vote on the document Mr. Chopra prepared. This was a brazen attempt to seize control from the FDIC executive secretary, who alone is in charge of official board distributions. Board members were immediately notified by the FDIC's general counsel that the CFPB's communication didn't constitute a valid board distribution and therefore couldn't be recorded as official board action.

On Dec. 6, the FDIC staff produced a document to board members that was factual and neutral in tone, informed by the expertise of career staff—a genuine effort to solicit public feedback without politicizing the agency or the process. It asked broad-based questions on the statutory factors that govern merger applications and whether the FDIC's existing approach is appropriate.

Within hours of receiving that document, board members responded by attempting to vote on the original CFPB document. Board member Martin Gruenberg, a former chairman, electronically signed his alleged vote on Dec. 3, three days before receiving the FDIC

document for review. When board members were informed that their actions didn't constitute a valid vote, Messrs. Chopra and Gruenberg posted their document on the CFPB's website and claimed it was an official FDIC issuance.

Of the 20 chairmen who preceded me at the FDIC, nine faced a majority of the board members from the opposing party, including Mr. Gruenberg as chairman under President Trump until I replaced him as chairman in 2018. Never before has a majority of the board attempted to circumvent the chairman to pursue their own agenda.

This conflict isn't about bank mergers. If it were, board members would have been willing to work with me and the FDIC staff rather than attempt a hostile takeover of the FDIC internal processes, staff and board agenda.

This episode is an attempt to wrest control from an independent agency's chairman with a change in the administration. More than that, it's an example of the erosion of America's democracy. Many government institutions are built on norms and practices that encourage parties to work together. This foundation depends on agency leaders who recognize that the long-term benefits of cooperation outweigh the short-term incentive to blow up institutions in pursuit of immediate partisan gains. Since the FDIC's founding in 1933, all 72 board members have respected that foundation. Until now.

When I arrived in the U.S. from Yugoslavia alone on my 18th birthday, I had $500 in my pocket. I came to this country with a firm belief in a system of government built upon the rule of law. In the old country, those in power all too often changed the rules and circumvented protocols to enact their preferred policies. When I was sworn in as chairman, I promised myself that I would lead the FDIC with deliberation and due care.

The FDIC's core mission to protect depositors resonates with me. My family's meager savings disappeared overnight when a local bank collapsed at the onset of Yugoslavia's civil war. Yugoslavia didn't have deposit insurance. At 68, my father went to work as a laborer earning $5 a day. You don't need that kind of firsthand experience to understand why stability at the FDIC is paramount for our nation.

I will continue to manage the agency pursuant to the oath I took. And my door is always open to those willing to engage in a manner that befits the venerated institution we are privileged to serve.

Ms. McWilliams has been chairman of the FDIC since 2018.

https://www.wsj.com/articles/why-im-resigning-from-the-ftc-commissioner-ftc-lina-khan-regulation-rule-violation-antitrust-339f115d

OPINIONCOMMENTARY Follow

Why I'm Resigning as an FTC Commissioner

Lina Khan's disregard for the rule of law and due process make it impossible for me to continue serving.

Wilson

:08 pm ET

FTC Chairman Lina Khan speaks on Capitol Hill, April 21, 2021.

PHOTO: GRAEME JENNINGS/ASSOCIATED PRESS

Much ink has been spilled about Lina Khan's attempts to remake federal antitrust law as chairman of the Federal Trade Commission. Less has been said about her disregard for the rule of law and due process and the way senior FTC officials enable her. I have failed repeatedly to persuade Ms. Khan and her enablers to do the right thing, and I refuse to give their endeavor any further hint of legitimacy by remaining. Accordingly, I will soon resign as an FTC commissioner.

Since Ms. Khan's confirmation in 2021, my staff and I have spent countless hours seeking to uncover her abuses of government power. That task has become increasingly difficult as she has consolidated power within the Office of the Chairman, breaking decades of bipartisan precedent and undermining the commission structure that Congress wrote into law. I have sought to provide transparency and facilitate accountability through speeches and

statements, but I face constraints on the information I can disclose—many legitimate, but some manufactured by Ms. Khan and the Democratic majority to avoid embarrassment.

Consider the FTC's challenge to Meta's acquisition of Within, a virtual-reality gaming company. Before joining the FTC, Ms. Khan argued that Meta should be blocked from making any future acquisitions and wrote a report on the same issues as a congressional staffer. She would now sit as a purportedly impartial judge and decide whether Meta can acquire Within. Spurning due-process considerations and federal ethics obligations, my Democratic colleagues on the commission affirmed Ms. Khan's decision not to recuse herself.

I dissented on due-process grounds, which require those sitting in a judicial capacity to avoid even the appearance of unfairness. The law is clear. In one case, a federal appeals court ruled that an FTC chairman who investigated the same company, conduct, lines of business and facts as a committee staffer on Capitol Hill couldn't then sit as a judge at the FTC and rule on those issues. In two other decisions, appellate courts held that an FTC chairman couldn't adjudicate a case after making statements suggesting he prejudged its outcome. The statements at issue were far milder than Ms. Khan's definitive pronouncement that all Meta acquisitions should be blocked. These cases, with their uncannily similar facts, confirm that Ms. Khan's participation would deny the merging parties their due-process rights.

I also disagreed with my colleagues on federal ethics grounds. To facilitate transparency and accountability, I detailed my concerns in my dissent—but Ms. Khan's allies ensured the public wouldn't learn of them. Despite previous disclosures of analogous information, Commissioners Rebecca Slaughter and Alvaro Bedoya imposed heavy redactions on my dissent. Commission opinions commonly use redactions to prevent disclosure of confidential business information, but my opinion contained no such information. The redactions served no purpose but to protect Ms. Khan from embarrassment.

I am not alone in harboring concerns about the honesty and integrity of Ms. Khan and her senior FTC leadership. Hundreds of FTC employees respond annually to the Federal Employee Viewpoint Survey. In 2020, the last year under Trump appointees, 87% of surveyed FTC employees agreed that senior agency officials maintain high standards of honesty and integrity. Today that share stands at 49%.

Many FTC staffers agree with Ms. Khan on antitrust policy, so these survey results don't necessarily reflect disagreement with her ends. Instead, the data convey the staffers' discomfort with her means, which involve dishonesty and subterfuge to pursue her agenda. I disagree with Ms. Khan's policy goals but understand that elections have consequences. My

fundamental concern with her leadership of the commission pertains to her willful disregard of congressionally imposed limits on agency jurisdiction, her defiance of legal precedent, and her abuse of power to achieve desired outcomes.

Three additional examples are illustrative. In November 2022, the commission issued an antitrust enforcement policy statement asserting that the FTC could ignore decades of court rulings and condemn essentially any business conduct that three unelected commissioners find distasteful. If conduct can be labeled with a nefarious adjective—"coercive," "exploitative," "abusive," "restrictive"—it may violate the FTC Act of 1914. But the new policy contains no descriptions or definitions of these terms, many of which also lack context in the law. The commission also candidly explained that its analysis under the new policy may depart from prior antitrust precedent, and identified previously lawful conduct as now suspect. In other words, the new policy adopts an "I know it when I see it" approach. But due process demands that the lines between lawful and unlawful conduct be clearly drawn, to guide businesses before they face a lawsuit.

In January 2023, the commission launched a rulemaking that would ban nearly all noncompete clauses in employee contracts, affecting roughly one-fifth of employment contracts in the U.S. This proposed rule defies the Supreme Court's decision in *West Virginia v. EPA* (2022), which held that an agency can't claim "to discover in a long-extant statute an unheralded power representing a transformative expansion in its regulatory authority."

Under President Biden, FTC leadership has abused the merger review process to impose a tax on all mergers, not only those that hinder competition. Progressives tried but failed to enact a legislative moratorium on mergers in early 2020 and to pass other restrictions since. Ms. Khan now does so by fiat. Abuse of regulatory authority now substitutes for unfulfilled legislative desires.

We all know the simple rule: If you see something, say something. As an antitrust lawyer, I counseled clients to avoid trouble by knowing when to object and how to exit. When my clients attended trade association gatherings, I advised them to leave quickly if discussions with competitors took a wrong turn and raised alarm bells about price fixing or other illegal activity. Make a noisy exit—say, spill a pitcher of water—so that attendees remember that you objected and that you left. Although serving as an FTC commissioner has been the highest honor of my professional career, I must follow my own advice and resign in the face of continuing lawlessness. Consider this my noisy exit.

Mrs. Wilson is a Republican-appointed commissioner at the Federal Trade Commission.

OPINIONREVIEW & OUTLOOK Follow

The FTC's Unholy Antitrust Grail

The agency overrules its own law judge to block Illumina's acquisition.

rial Board Follow

20 pm ET

The offices of gene sequencing company Illumina Inc. in San Diego.
PHOTO: MIKE BLAKE/REUTERS

The Federal Trade Commission on Monday overruled its own in-house judge and ordered gene-sequencing giant Illumina to divest cancer blood-test startup Grail. FTC Chair Lina Khan is showing that the agency's administrative trials are a sham. Heads the agency wins, tails businesses lose.

A FTC judge in September issued a 203-page opinion rejecting the agency's complaint that alleged the Grail acquisition would harm potential competitors in the embryonic market for multi-cancer early detection tests. Grail currently has no competitors, and the FTC complaint relies on speculative theories.

Illumina makes the platforms that are used to run Grail and other genetic screening tests. Its scientists developed Grail's technology before the company spun off the startup in 2016. As the Grail test improved and became commercially viable, Illumina sought to reacquire Grail and closed its acquisition in August 2021.

Grail claims its test can detect the 12 most deadly cancers with 76% accuracy and has a false positive rate of less than 1%. Earlier detection of aggressive cancers could save thousand of lives a year. Illumina says it can bring the test to market faster owing to its relationships with insurers and reduce the price, now about $949 out of pocket.

But some companies that were interested in buying Grail or that were developing their own cancer tests complained to the FTC that Illumina would thwart rivals. This was the gist of the FTC complaint, which the agency's in-house judge dismissed after a detailed analysis of the facts. Administrative law judges are rarely so scathing.

"The Clayton Act protects competition, not competitors," FTC chief administrative law judge D. Michael Chappell wrote, emphasizing that "antitrust theory and speculation cannot trump facts." He concluded that the FTC had failed to prove its case that Illumina had the ability and incentive to help Grail to the disadvantage of alleged rivals.

For Illumina to divert sales from multi-cancer early detection rivals to Grail, other "test developers would have to have sales in the first place," he explained. But none do. He also noted that Illumina had offered a contractual commitment to provide access to its products to all of its future oncology testing customers equivalent to that it provides to Grail.

The FTC commissioners disagreed with the judge 4-0 and ordered Illumina to unwind its Grail acquisition. Republican Commissioner Christine Wilson wrote in a concurrence that she disagreed with some of her colleagues' legal analysis, but she didn't believe Illumina had met its burden of proof to show the government's competition theory was improbable.

Ms. Khan seems to be trying to make an example out of Illumina by ordering the company to pay "transition assistance" to Grail's next acquirer plus expenses of a government-appointed special monitor to ensure that it complies with the divestiture order. The tacit message to other businesses is don't dare consummate a merger that the agency challenges.

The FTC could have gone to federal court to try to stop the acquisition. Instead it challenged the deal in its administrative tribunal where it no doubt believed it was more likely to win because it almost always does. Yet after losing, it has now overruled its own judge. What was the purpose of the administrative trial if the FTC could ignore the judge's findings and do whatever it wants anyway?

That's a good question for the independent federal courts. Illumina plans to appeal the divestiture order in federal appellate court where it will have the opportunity to raise several

constitutional challenges to the FTC's authority and administrative proceeding that it had earlier raised before the commission. This could get interesting, and the FTC may come to regret its hell-bent effort to stop mergers by whatever means possible.

Appeared in the April 4, 2023, print edition as 'The FTC's Unholy Antitrust Grail'.

UNITED STATES OF AMERICA
Federal Trade Commission
WASHINGTON, D.C. 20580

Office of the Chair

September 28, 2021

The Honorable David Cicilline
Chair
Subcommittee on Antitrust, Commercial, and Administrative Law
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Ken Buck
Ranking Member
Subcommittee on Antitrust, Commercial, and Administrative Law
U.S. House of Representatives
Washington, D.C. 20515

Dear Chair Cicilline and Ranking Member Buck:

Thank you for the opportunity to provide my views as part of the Subcommittee's hearing entitled "Reviving Competition Part 4: 21st Century Antitrust Reforms and the American Worker" and for your leadership on this critical issue.

Empirical research today shows that labor markets across the United States have grown highly concentrated, resulting in lower wages and less bargaining power for workers.[1] Dominant firms, meanwhile, exploit current laws to exert significant control over workers even while classifying them as non-employees.[2] These asymmetric relationships often enable firms to impose take-it-or-leave-it contract terms that disfavor workers, including, for example, noncompete clauses. Recent lawsuits have also highlighted no-poach agreements among employers, which can further restrict workers and depress wages.[3]

The Federal Trade Commission is charged with rooting out unfair methods of competition and unfair or deceptive practices in the economy, a mandate that protects all Americans, including workers. In service of this goal, the FTC is taking a series of steps to adjust its approach.

First, I have instructed staff to investigate potentially unlawful mergers or conduct that harm workers. Although antitrust law in recent decades generally has neglected monopsony concerns and harms to workers, we must scrutinize mergers that may substantially lessen competition in labor markets. As part of this effort, the FTC will work with the Department of Justice to update the agencies' merger

[1] *See, e.g.*, Jose Azar, Ioana Marinescu, and Marshall Steinbaum, *Labor Market Concentration*, J. HUMAN RESOURCES (2020).
[2] *See, e.g.*, Marshall Steinbaum, *Monopsony and the Business Model of Gig Economy Platforms*, ORG. ECON. CO-OPERATION & DEV. (Sept. 17, 2020), https://one.oecd.org/document/DAF/COMP/WD(2019)66/en/pdf.
[3] *See, e.g.*, Press Release, Dept. of Just., DaVita Inc. and Former CEO Indicted in Ongoing Investigation of Labor Market Collusion in Health Care Industry (July 15, 2021), https://www.justice.gov/opa/pr/davita-inc-and-former-ceo-indicted-ongoing-investigation-labor-market-collusion-health-care.

guidelines, looking to provide guidance on how to analyze a merger's impact on labor markets.[4] Illegal restraints on worker pay or opportunity can also significantly harm workers, and employers must not get a free pass. The FTC's complaint earlier this year alleging that Amazon misled its Flex drivers when diverting their tips additionally highlights how deceptive conduct that cheats workers may be unlawful.[5]

Second, the FTC is scrutinizing whether certain contract terms, particularly in take-it-or-leave-it contexts, may violate the law. Workers are at a significant disadvantage when they are unable to negotiate freely over the terms and conditions of their employment. The FTC has heard concerns about noncompete clauses at its open meetings, and the Commission recently opened a docket to solicit public comment on the prevalence and effects of contracts that may harm fair competition.[6] As we pursue this work, I am committed to considering the Commission's full range of tools, including enforcement and rulemaking.

Third, the FTC should be judicious in its use of scarce resources, focusing its antitrust enforcement on tackling monopolization or mergers involving dominant firms. Although Section 6 of the Clayton Act exempts labor organizing from the Act's purview,[7] federal courts have held that these protections apply only to workers formally classified as employees.[8] As a result, collective action and organizing by certain workers—including those who have the terms of their work dictated by a firm yet are classified as non-employees—may be susceptible to prosecution under the antitrust laws.[9] Private plaintiffs can pursue these lawsuits even in the absence of action by the U.S. agencies, and in these instances I will work with the DOJ to consider providing guidance to the courts on how the Clayton Act is designed to exempt worker organizing activities from antitrust.

---

[4] Statement of Chair Lina M. Khan, Comm'r Rohit Chopra, and Comm'r Rebecca Kelly Slaughter on the Withdrawal of the Vertical Merger Guidelines, File No. P810034 (Sept. 15, 2021), https://www.ftc.gov/public-statements/2021/09/statement-chair-lina-m-khan-commissioner-rohit-chopra-commissioner-rebecca.

[5] Press Release, Fed. Trade Comm'n, Amazon To Pay $61.7 Million to Settle FTC Charges It Withheld Some Customer Tips from Amazon Flex Drivers (Feb. 2, 2021), https://www.ftc.gov/news-events/press-releases/2021/02/amazon-pay-617-million-settle-ftc-charges-it-withheld-some.

[6] Request for Public Comment Regarding Contract Terms That May Harm Fair Competition, Docket No. FTC-2021-0036, https://www.regulations.gov/docket/FTC-2021-0036/document (last visited Sept. 28, 2021).

[7] 15 U.S.C. § 17.

[8] *L.A. Meat & Provision Drivers Union, Local 626* v. United States, 371 U.S. 94 (1962); *United States v. Women's Sportswear Mfg. Ass'n*, 336 U.S. 460 (1949); *Columbia River Packers Ass'n v. Hinton*, 315 U.S. 143 (1942). *See also* Robert Pitofsky, Chairman, Fed. Trade Comm'n, Concerning H.R. 1304: The "Quality Health-Care Coalition Act of 1999," Prepared Statement of the Federal Trade Commission Before the Committee on the Judiciary, United States House of Representatives 3 (June 22, 1999), https://www.ftc.gov/sites/default/files/documents/public_statements/preparedstatement-federal-trade-commission-quality-health-care-coalition-act/healthcaretestimony.pdf ("[P]hysicians who are employees (for example, of hospitals) are already covered by the labor exemption under current law. The labor exemption, however, is limited to the employer-employee context, and it does not protect combinations of independent business people.").

[9] *See Columbia River Packers Ass'n v. Hinton*, 315 U.S. 143, 145 (1942) ("That a dispute among businessmen over the terms of a contract for the sale of fish is something different from a controversy concerning terms or conditions of employment, or concerning the association of persons seeking to arrange terms or conditions of employment calls for no extended discussion. This definition and the stated public policy of the Act — aid to the individual unorganized worker commonly helpless to obtain acceptable terms and conditions of employment and protection of the worker from the interference, restraint, or coercion of employers of labor — make it clear that the attention of Congress was focussed upon disputes affecting the employer-employee relationship, and that the Act was not intended to have application to disputes over the sale of commodities.") (internal citations and quotation marks omitted); *see also L.A. Meat & Provision Drivers Union, Local 626 v. United States*, 371 U.S. 94, 102-03 (1962) ("Here, as in *Columbia River Co.,* the grease peddlers were sellers of commodities, who became 'members' of the union only for the purpose of bringing union power to bear in the successful enforcement of the illegal combination in restraint of the traffic in yellow grease.").

Congress could also pursue legislative reforms that grant workers greater protections under the antitrust laws. For example, legislation clarifying that labor organizing by workers regarding the terms and conditions of their work is outside the scope of the federal antitrust statutes, regardless of whether the worker is classified as an employee, would remove the threat of antitrust liability resulting from such coordination. This type of clarification could have far-reaching effects, especially given the prevalence and expansion of "gig economy" firms that rely heavily on workers classified as non-employees. As federal lawmakers consider antitrust legislation to better protect labor, state efforts with similar aims could also provide a useful model.[10]

Thank you for your leadership on promoting fair competition and protecting workers. If you have any questions, please feel free to have your staff call Jeanne Bumpus, the Director of our Office of Congressional Relations, at (202) 326-2195.

Sincerely,

Lina M. Khan
Chair, Federal Trade Commission

[10] *See, e.g.*, Twenty-First Century Anti-Trust Act, S. 933, Reg. Sess. (N.Y. 2021).

The Honorable Cathy McMorris Rodgers
Chair
House Committee on Energy and Commerce
United States House of Representatives
Washington, D.C. 20515

The Honorable Frank Pallone
Ranking Member
House Committee on Energy and Commerce
United States House of Representatives
Washington, D.C. 20515

The Honorable Gus Bilirakis
Chair
Subcommittee on Innovation, Data, and Commerce
House Committee on Energy and Commerce
United States House of Representatives
Washington, D.C. 20515

The Honorable Jan Schakowsky
Ranking Member
House Committee on Energy and Commerce
United States House of Representatives
Washington, D.C. 20515

Dear Chair McMorris Rodgers, Ranking Member Pallone, Chair Bilirakis, and Ranking Member Schakowsky,

We write to you as a coalition of businesses and groups committed to reinvigorating competition in the digital economy. For decades, the United States' position as a global leader in technological innovation has been powered by small and medium-sized enterprises across the country. As the committee "at the forefront of all issues and policies powering America's economy,"[1] the House Committee on Energy and Commerce has broad jurisdiction over these and related issues.

The rise of monopoly power in the tech sector has tilted the playing field against emerging innovators and ultimately put America's global leadership in jeopardy.[2] It has also left consumers with fewer choices and that is why we support legislation to curb anticompetitive behavior by the largest technology platforms. Despite wide bipartisan support and backing from

[1] https://energycommerce.house.gov/
[2] https://www.cnbc.com/2020/07/30/us-lawmakers-agree-big-tech-has-too-much-power-remedies-unclear.html

leading small business advocacy groups,[3] this legislation to rein in Big Tech has, unfortunately, fallen short to date of making it into law.[4]

We commend the Federal Trade Commission (FTC) and Department of Justice (DoJ) for using their full set of tools and authorities to take important steps to curb anticompetitive self-preferencing behavior by the largest platforms. We support these actions.

We urge the House Energy & Commerce Committee to support the FTC and DoJ in the months ahead in their efforts to reinvigorate the spirit of competition and innovation in the American economy.

Sincerely,

Andi Search
Beeper
Brave
Dots
Efani Mobile
Felt
Kelkoo Group
LI Toy & Game
Mio
Neeva
Patreon
Proton
Responsible Online Commerce Coalition
SparkToro
Thexyz
Tutanota
Yelp
Y Combinator

[3] https://www.nfib.com/content/press-release/homepage/nfib-supports-antitrust-legislation-to-level-digital-economy-for-small-businesses/
[4] https://www.washingtonpost.com/business/on-small-business/big-tech-dividedand-conqueredtoblockkey-bipartisan-bills/2022/12/20/529255b6-804f-11ed-8738-ed7217de2775_story.html

Congress of the United States

Washington, DC 20515

September 21, 2022

Chairwoman Lina Khan
U.S. Federal Trade Commission
600 Pennsylvania Avenue, NW
Washington, D.C. 20580

Dear Chairwoman Lina Khan,

We write regarding the proposed Motor Vehicle Dealers Trade Regulation Rule, issued by the Federal Trade Commission on July 13, 2022. The public comment period ended September 12, 2022.

This rule would affect tens of millions of consumer transactions annually. Unfortunately, due to the short period for public comment, many stakeholders and constituents were not able to submit feedback. It appears that many of the Rule's new requirements were prepared without any testing to determine their actual impact in the market. This information would provide critical feedback to the Commission.

Since the Commission regrettably failed to issue an advance notice of the proposed rulemaking in accordance with Section 1.10 of the Commission's procedural rules, the extensive set of questions included in the proposed rule should have preceded the issuance of the proposed rule itself. A major concern articulated by stakeholders relates to the fact that consumer transactions have already been regulated under existing law. Furthermore, the proposed measures would inject unintended costs into the auto retailing process and massively extend transactional times.

Recognizing the importance of the matter and supporting the Commission in its efforts to protect customers and honest dealers from retail sales fraud practices by making the automotive buying process clearer and more competitive, we request the FTC to reopen the deadline for comments to be submitted on the proposed rule for an additional sixty to ninety days.

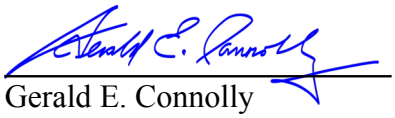
Thank you for your attention to this deadline extension request. We look forward to your cooperation so that all actors concerned have the chance to express their opinion on this matter.

Sincerely,

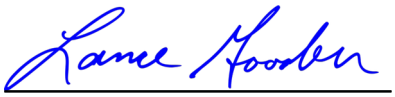
Chris Pappas
Member of Congress

Doug LaMalfa
Member of Congress

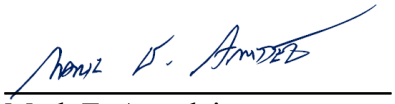
Jesús G. "Chuy" García
Member of Congress



Gerald E. Connolly
Member of Congress



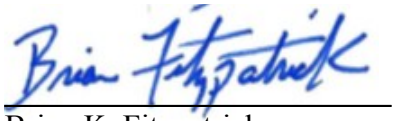
Lance Gooden
Member of Congress



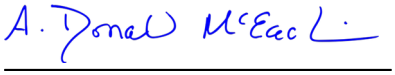
Mark E. Amodei
Member of Congress

Russ Fulcher
Member of Congress

Dusty Johnson
Member of Congress



Brian K. Fitzpatrick
Member of Congress



A. Donald McEachin
Member of Congress

Doug Lamborn
Member of Congress

Brian J. Mast
Member of Congress

Brian Higgins
Member of Congress

Michael Waltz
Member of Congress

Mariannette Miller-Meeks, M.D.
Member of Congress

Ben Cline
Member of Congress

Mary E. Miller
Member of Congress

Thomas R. Suozzi
Member of Congress

Cliff Bentz
Member of Congress

David G. Valadao
Member of Congress

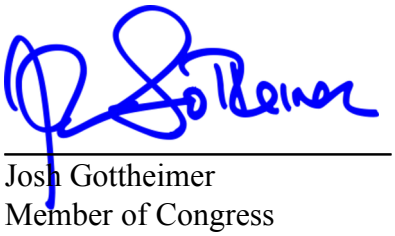
Bruce Westerman
Member of Congress

Ann McLane Kuster
Member of Congress

Dina Titus
Member of Congress

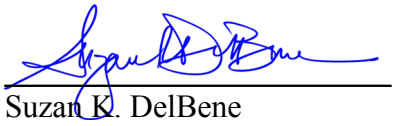
Lisa Blunt Rochester
Member of Congress

Barry Loudermilk
Member of Congress

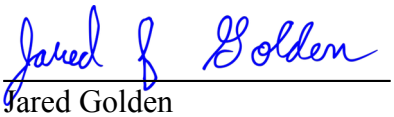


Josh Gottheimer
Member of Congress

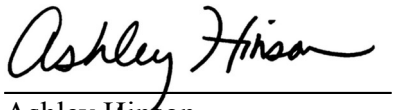
Michael Guest
Member of Congress



Suzan K. DelBene
Member of Congress



Jared Golden
Member of Congress



Ashley Hinson
Member of Congress

FEDERAL TRADE COMMISSION
PROTECTING AMERICA'S CONSUMERS

For Release

Federal Trade Commission, National Labor Relations Board Forge New Partnership to Protect Workers from Anticompetitive, Unfair, and Deceptive Practices

New Agreement Will Strengthen Collaboration Between the Two Agencies

July 19, 2022
Tags: Consumer Protection | Competition | Office of Policy Planning | Bureau of Competition | Bureau of Consumer Protection

The Federal Trade Commission is joining with the National Labor Relations Board (NLRB) in a new agreement that will bolster the FTC's efforts to protect workers by promoting competitive U.S. labor markets and putting an end to unfair practices that harm workers. The new memorandum of understanding between the two agencies outlines ways in which the Commission and the Board will work together moving forward on key issues such as labor market concentration, one-sided contract terms, and labor developments in the "gig economy."

"I'm committed to using all the tools at our disposal to ensure that workers are protected from unfair methods of competition and unfair or deceptive practices," said FTC Chair Lina M. Khan. "This agreement will help deepen our partnership with NLRB and advance our shared mission to ensure that unlawful business practices aren't depriving workers of the pay, benefits, conditions, and dignity that they deserve."

"Workers in this country have the right under federal law to act collectively to improve their working conditions. When businesses interfere with those rights, either through unfair labor practices, or anti-competitive conduct, it hurts our entire nation," said NLRB General Counsel Jennifer A. Abruzzo. "This MOU is critical to advancing a whole of government approach to combating unlawful conduct that harms workers."

The new agreement enables the FTC and the NLRB to closely collaborate by sharing information, conducting cross-training for staff at each agency, and partnering on investigative efforts within each agency's authority. The FTC is responsible for combatting unfair and deceptive acts and practices and unfair methods of competition in the marketplace. The NLRB is responsible for protecting employees from unfair labor practices which interfere with the rights of employees to join together to improve their wages and working conditions, to organize a union and bargain collectively, and to engage in other protected concerted activity.

The MOU identifies areas of mutual interest for the two agencies, including the extent and impact of labor market concentration; the imposition of one-sided and restrictive contract provisions, such as noncompete and nondisclosure provisions; labor market developments relating to the "gig economy" and other alternative work arrangements; claims and disclosures about earnings and costs associated with gig and other work; the impact of algorithmic decision-making on workers; the ability of workers to act collectively; and the classification and treatment of workers.

The agreement is part of a broader FTC initiative to use the agency's full authority, including enforcement actions and Commission rulemaking, to protect workers. The FTC has made it a priority to scrutinize mergers that may harm competition in U.S. labor markets. Research shows that these markets are already highly concentrated, and less competitive labor markets can enable firms to harm workers by lowering wages, reducing benefits, and perpetuating precarious or exploitative working conditions. The FTC is working with the Department of Justice to update the agencies' merger guidelines, looking to provide guidance on how to analyze a merger's impact on labor markets.

The FTC has also prioritized cracking down on anticompetitive contract terms that put workers at a disadvantage by leaving them unable to negotiate freely over the terms and conditions of their employment. The agency is scrutinizing whether some of these contract terms, particularly in take-it-or-leave-it contexts, may violate the law. At recent open Commission meetings the agency has heard concerns about noncompete clauses that have been imposed on some workers, and as a result it has opened a docket to solicit public comment on the prevalence and effects of contracts that may harm fair competition. It already has taken action to protect workers in several Commission orders, including:

- Prohibiting 7-Eleven from enforcing anticompetitive noncompete agreements last year as part of an order remedying competition concerns stemming from 7-Eleven, Inc's acquisition of Marathon's Speedway subsidiary; and

- Prohibiting dialysis services provider DaVita, Inc. from imposing undue restrictions on kidney dialysis worker mobility as part of another FTC order remedying competitive concerns with from DaVita's proposed acquisition of the University of Utah Health's dialysis clinics.

In addition, the agency will continue to take action to stop deceptive and unfair acts and practices aimed at workers; particularly those in the "gig economy" who often don't enjoy the full protections of traditional employment relationships. The FTC's actions in this area include:

- Suing Amazon in 2021 for illegally withholding more than $61 million in tips from drivers for its Amazon Flex program. In that case, the FTC alleged that Amazon had made numerous promises to its drivers that they would receive 100 percent of their tips, but actually withheld tip money from its drivers for years. Amazon agreed to an FTC order requiring them to surrender the full amount owed, which the FTC paid to affected drivers;

- Suing Uber in 2017 for making deceptive earnings claims to potential drivers as well as deceiving them about the terms of a vehicle leasing program. The FTC alleged that the company touted median income levels in various cities that were greatly exaggerated and advertised lease and purchases prices lower than the prices actually available. Uber agreed to a federal court order requiring them to surrender $20 million that the FTC used to compensate drivers;

- Launching a proceeding to challenge bogus money-making claims used to lure consumers, workers, and prospective entrepreneurs into risky business ventures that often turn into dead-end debt traps;

- Putting more than 1,100 businesses that pitch money-making ventures on notice that if they deceive or mislead consumers about potential earnings, the FTC won't hesitate to use its authority to target them with large civil penalties;

- Suing online lead seller HomeAdvisor, Inc., alleging it used deceptive and misleading tactics in selling home improvement project leads to service providers, including small businesspeople operating in the "gig" economy; and

- Suing fast-food chain Burgerim, accusing the chain and its owner of enticing more than 1,500 consumers to purchase franchises using false promises while withholding information required by the Franchise Rule.

Workers who believe that their labor rights have been violated can call 1-844-762-6572 for assistance filing an unfair labor practice charge. Or they can contact their closest NLRB Field Office or submit a charge on the NLRB's website.

The memorandum of understanding was signed by FTC Chair Lina M. Khan and NLRB General Counsel Jennifer A. Abruzzo.

The Federal Trade Commission works to promote competition, and protect and educate consumers. You can learn more about how competition benefits consumers or file an antitrust complaint. For the latest news and resources, follow the FTC on social media, subscribe to press releases and read our blog.

Contact Information

Media Contact

Jay Mayfield
Office of Public Affairs
202-326-2656

Kayla Blado
NLRB Public Affairs

News & Publications

NLRB Issues Notice of Proposed Rulemaking on Joint-Employer Standard

Office of Public Affairs
202-273-1991
publicinfo@nlrb.gov
www.nlrb.gov

September 06, 2022

Today, the National Labor Relations Board released a Notice of Proposed Rulemaking (NPRM) addressing the standard for determining joint-employer status under the National Labor Relations Act. The NPRM proposes to rescind and replace the joint-employer rule that took effect on April 27, 2020. The proposed changes are intended to explicitly ground the joint-employer standard in established common-law agency principles, consistent with Board precedent and guidance that the Board has received from the U.S. Court of Appeals for the DC Circuit.

Under the proposed rule, two or more employers would be considered joint employers if they "share or codetermine those matters governing employees' essential terms and conditions of employment," such as wages, benefits and other compensation, work and scheduling, hiring and discharge, discipline, workplace health and safety, supervision, assignment, and work rules. The Board proposes to consider both direct evidence of control and evidence of reserved and/or indirect control over these essential terms and conditions of employment when analyzing joint-employer status.

"In an economy where employment relationships are increasingly complex, the Board must ensure that its legal rules for deciding which employers should engage in collective bargaining serve the goals of the National Labor Relations Act," said Chairman Lauren McFerran. "Part of that task is providing a clear standard for defining joint employment that is consistent with controlling law. Unfortunately, the Board's joint employer standard has been subject to a great deal of uncertainty and litigation in recent years. Rulemaking on this issue allows for valuable input from members of the public that will help the Board in its effort to bring clarity and certainty to these significant questions."

Chairman McFerran was joined by Board Members Gwynne A. Wilcox and David M. Prouty in proposing the new joint-employer standard. Board Members Marvin E. Kaplan and John F. Ring dissented.

Public comments are invited on all aspects of the proposed rule and should be submitted either electronically to regulations.gov, or by mail or hand-delivery to Roxanne Rothschild, Executive Secretary, National Labor Relations Board, 1015 Half Street S.E., Washington, D.C. 20570-0001.

Comments on this proposed rule must be received by the NLRB on or before November 7, 2022. Comments replying to comments submitted during the initial comment period must be received by the Board on or before November 21, 2022.

Established in 1935, the National Labor Relations Board is an independent federal agency that protects employees from unfair labor practices and protects the right of private sector employees to join together, with or without a union, to improve wages, benefits and working conditions. The NLRB conducts hundreds of workplace elections and investigates thousands of unfair labor practice charges each year.

Most Popular Pages

Who We Are
National Labor Relations Act
Cases & Decisions
Recent Charges & Petitions Filings
The Law
The Right to Strike
Case Search
Contact Us
Frequently Asked Questions

Connect With NLRB

Federal Trade Commission
600 Pennsylvania Ave., NW
Washington, D.C. 20580

April 12, 2023

Re: Confidentiality of Agency Investigations

Dear General Counsel Dasgupta,

As alumni of the Federal Trade Commission, we have devoted significant portions of our careers to protecting consumers and competition. As many of us explained in a letter dated September 20, 2022 (attached), we continue to care deeply about the Agency and its mission. We strongly support the FTC's efforts to develop meritorious cases to enforce the competition and consumer protection laws.

In this spirit, we write to alert you to a concern about the integrity and fairness of the Agency's investigations -- one that ultimately could cost the FTC in court. In several instances, there is concern that agency personnel may have leaked confidential information, or their analyses of confidential information, to the media about ongoing investigations. If this has happened, such disclosures would compromise the integrity of the Agency's processes, unfairly damage the reputations of the subject individuals and companies, and arguably violate both federal law and basic notions of procedural fairness and due process. Accordingly, we urge you to reassure the public, and to remind all agency personnel, that the Agency's investigations will and must remain confidential.

A. The Importance of Confidentiality

Confidentiality protects both the Agency itself and the individuals and companies who are the subject of the Agency's probes. For individuals and companies, confidentiality protects their reputations. Negative publicity and unsubstantiated speculation can cost a company goodwill, trust, new opportunities, and ultimately revenue. Confidentiality also protects their ability to receive due process, free from taint or bias. If agency personnel leak sensitive information or condemn individuals and companies in the media, without the benefit of due process or an opportunity for rebuttal, those statements can unfairly prejudice the proceedings.[1]

Confidentiality also insulates the Commission from charges of bias. When the Agency investigates an individual or company and decides to bring charges, without leaks, the public, the courts, and even the defendants themselves can have confidence that the FTC considered all the evidence in a neutral and objective manner. Leaks, however, undermine the appearance of objectivity. Leaks suggest that the Agency has decided to condemn an individual or company prior to the end of the investigation, without the benefit of all the information, and regardless of whether the Agency thinks it can prevail in court.

[1] See generally Department of Justice Manual, Confidentiality and Media Contacts Policy 1-7.000, at https://www.justice.gov/jm/jm-1-7000-media-relations.

Moreover, leaks could compromise the effectiveness of the Agency's law enforcement mission. Leaks diminish the willingness of the individuals and companies, and of third-party witnesses, to cooperate with the Agency's investigations. Without confidence in the confidentiality of the Agency's proceedings, many individuals and companies may choose to provide information to the Agency only under court order. This result could hamstring the Agency's ability to gather the necessary evidence to develop cases to protect consumers. Perhaps of greatest concern, investigatory leaks could give defendants grounds to challenge adverse decisions in court. It would be a terrible waste of resources, and quite damaging to consumers, for a court to reverse a hard-fought agency victory because leaks biased the case's outcome.

For all these reasons, federal law and policy protect the confidentiality of the Agency's investigations. Under the FTC Act, 15 U.S.C § 50, "Any officer or employee of the Commission who shall make public any information obtained by the Commission without its authority, unless directed by a court, shall be deemed guilty of a misdemeanor." Under the Hart-Scott-Rodino Act's premerger notification program, 15 USC 18(a)(h), no information filed with the FTC "may be made public, except as may be relevant to any administrative or judicial action or proceeding." The FTC, the Department of Justice, and the courts all have affirmed the importance of confidentiality in agency investigations.[2]

B. Media Reports of Confidential Information

Despite the importance of confidentiality, recent news stories have contained considerable amounts of sensitive information about ongoing agency investigations. Among other confidential material, these stories include information about the issuance of second requests, the timing of potential lawsuits, the merging parties' responses to the Agency, and the status of timing agreements between the Agency and the merging parties. Every story identifies the merging parties by name (out of respect for the confidentiality of the investigatory process, we will not include links to the articles, but internet searches would reveal them easily enough).

Based on their content, the stories strongly suggest that agency personnel have leaked sensitive material to the media. One article attributed leaked information to "an FTC official, who requested anonymity." Other stories disclosed the Agency's thought processes and planned response to various transactions. For example, one piece reported that the "agency's staff attorneys [are] leaning toward suing to stop [a particular acquisition] in the next few months." This article then described the Agency's concerns. Another story explained the Agency's thought processes in great detail, noting that the Agency brought suit to send a message to their counterparts abroad. Several articles divulge information known only to the Agency and investigated companies, and given the nature of the probes, it seems unlikely that the companies would have had an interest in leaking the information to the media.

---

[2] See U.S. Submission to the Organisation on Economic Co-operation and Development, *Working Party No. 3 on Co-operation and Enforcement* (Oct. 4, 2013) ("Many laws and rules at the federal level address confidentiality and privacy, requiring federal agencies to apply specific confidentiality and privacy protections for the information they receive from individuals, companies, or other governmental bodies"), at https://www.justice.gov/atr/file/787991/download; *Lieberman v. FTC*, 771 F.2d 32, 38 (2nd Cir. 1985) ("Congress wanted premerger information kept confidential").

In some of these stories, agency staff are quoted as condemning private companies, outside of the judicial process. In one article, for instance, agency personnel are quoted as saying that the merging companies had violated the antitrust laws, even though the Agency ultimately decided not to sue. According to the story, "agency officials[ ] belie[ved] that the deal was anticompetitive . . . [and] found evidence of anticompetitive behavior that many at the agency considered damning."

All of these stories raise troubling questions of fairness, due process, and improper reputational harm. "Guilt by anonymous quote" is particularly worrisome – if the Agency believes that an individual or company has violated the law, the Agency should put the matter to a vote and bring suit, giving the individual or company a chance to vindicate itself in court, or else close the matter without comment. Although governmental leaks have long been an issue of concern, in the midst of serious investigations, these apparent leaks would be inconsistent with both federal law and the American tradition of justice.

C. Recommendations

Whether or not agency personnel actually leaked confidential material to the media, given the articles, we urge you to reassure the public, and to remind all agency personnel, that the agency's investigations will and must remain confidential. Specifically, we urge you to send a memorandum to all agency personnel to remind them of their legal responsibility to maintain investigatory confidentiality and of the important rationale behind those laws. We also encourage you to assure the public that the agency is taking all necessary steps to maintain the confidentiality of its investigations. Such assurances will help the agency gain the cooperation of both the individuals and companies under scrutiny as well as of third parties.

Finally, given that the law requires confidentiality, we encourage you to examine this issue further. In particular, we encourage you to consult with the three remaining commissioners and, if appropriate, refer the topic of agency confidentiality to the FTC's Office of Inspector General. The agency's long-term effectiveness depends upon public confidence in the integrity of its investigations.

***

We trust that you share our belief in the importance of confidentiality. We stand ready to work with you to help the agency fulfill its important mission, both now and in the future.

Thank you for your attention to this matter.

cc: Chair Khan
Commissioner Bedoya
Commissioner Slaughter

Sincerely,

Alumni of the FTC[3]

[3] Every signatory is signing in his or her individual capacity, rather than on behalf of an organization.

Asheesh Agarwal
Former Assistant Director
Office of Policy Planning

Theodore A. Gebhard
Former FTC Senior Attorney
Office of Policy & Evaluation

Alden Abbott
Former General Counsel
Office of General Counsel

Bilal Sayyed
Former Director
Office of Policy Planning

Tom Pahl
Former Acting Director
Bureau of Consumer Protection

Liad Wagman
Former Senior Economic and Technology Advisor
Office of Policy Planning

Darren Tucker
Former Attorney Advisor
Offices of Former Commissioners Wright and Rosch

Dan Caprio
Former Attorney Advisor
Office of Commissioner Swindle

FEDERAL TRADE COMMISSION
PROTECTING AMERICA'S CONSUMERS

For Release

FTC, Justice Department, and European Commission Hold Third U.S.- EU Joint Technology Competition Policy Dialogue

March 30, 2023
Tags: Competition | Office of International Affairs | Bureau of Competition | Merger | Nonmerger | Unfair Methods of Competition | Government

Federal Trade Commission Chair Lina M. Khan, the Justice Department's Antitrust Division Assistant Attorney General Jonathan Kanter, and Executive Vice President Margrethe Vestager of the European Commission met today in Washington, D.C., for the third meeting of the U.S.-EU Joint Technology Competition Policy Dialogue (TCPD). The principals and senior staff met to continue work on cooperation in ensuring and promoting fair competition in the digital economy.

"The Joint Dialogue continues to provide an invaluable forum for the U.S. agencies to engage with the European Commission on challenges in digital markets," said FTC Chair Khan. "At this moment of unique risk and opportunity, it is especially critical that we deepen our cooperation with key enforcement partners."

"Agencies around the world are adjusting their competition enforcement and regulatory regimes to account for new market realities and in particular the challenges of the digital economy," said Assistant Attorney General Kanter. "Sharing best practices with the European Commission through the TCPD has been extraordinarily valuable to the U.S. agencies."

"Today's meeting has proven once again how fruitful it is to keep engaging in a close cooperation between the European Commission and the US competition authorities," said European Commission Executive Vice President Vestager. "Exchanging our experiences and ideas on how best to anticipate and address the fast-moving trends in tech markets is vital for achieving the shared goal of a fair, inclusive and pro-competitive digital transformation, to the benefit of consumers and businesses in both the EU and U.S."

The discussions centered on critical themes the agencies are facing, including the reasons mergers between digital players may lead to competition concerns. The agencies also shared policy reflections in the area of abuse of

From left to right: the Justice Department's Antitrust Division Assistant Attorney General Jonathan Kanter, Executive Vice President Margrethe Vestager of the European Commission, and Federal Trade Commission Chair Lina M. Khan.

dominance and monopolization in the digital sector and presented recent policy initiatives in this field. They also exchanged views on the evolving business strategies of big tech companies as well as on their implications for enforcement.

The agencies also announced planned liaisons of agency experts from the FTC and the Antitrust Division in Brussels, with each agency sending an official to assist with implementation of the Digital Markets Act (DMA).

On Dec. 7, 2021, the FTC, the Justice Department, and the European Commission launched the TCPD to further boost transatlantic cooperation on competition policy and enforcement in the digital sector in light of the common challenges facing the three authorities. Upon its launch, the Commission and U.S. competition agencies issued a statement regarding the TCPD and reaffirming their longstanding tradition of close cooperation on competition matters.

On June 15, 2021, President Biden and the European Commission President Ursula von der Leyen launched the U.S.-EU Trade and Technology Council (TTC). The TTC serves as a forum for the United States and European Union to coordinate approaches to key global trade, economic and technology issues and to deepen transatlantic trade and economic relations based on shared democratic values.

The FTC, the Justice Department, and the European Commission have a longstanding tradition of close cooperation in antitrust enforcement and policy, beginning even before the formal 1991 cooperation agreement between the European Commission and the United States regarding the application of their competition laws.

The Federal Trade Commission works to promote competition, and protect and educate consumers. You can learn more about consumer topics and report scams, fraud, and bad business practices online at ReportFraud.ftc.gov. Follow the FTC on social media, read our blogs and subscribe to press releases for the latest FTC news and resources.

Contact Information

Media Contact

Peter Kaplan
Office of Public Affairs
202-468-7684

JEFF DUNCAN
3RD DISTRICT, SOUTH CAROLINA

COMMITTEE ON ENERGY AND COMMERCE
CHAIRMAN, SUBCOMMITTEE ON ENERGY, CLIMATE, AND GRID SECURITY
SUBCOMMITTEE ON INNOVATION, DATA, AND COMMERCE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

DEPUTY REPUBLICAN WHIP

Congress of the United States
House of Representatives
Washington, DC 20515–4003

2229 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225–5301

303 WEST BELTLINE BOULEVARD
ANDERSON, SC 29625
(864) 224–7401

100 PLAZA CIRCLE, SUITE A1
CLINTON, SC 29325
(864) 681–1028

jeffduncan.house.gov

March 7, 2023

Honorable Gina Raimondo
Secretary
Department of Commerce
1401 Constitution Avenue, NW
Washington DC, 20230

Honorable Katherine C. Tai
U.S. Trade Representative
Office of the U.S. Trade Representative
600 17th Street, NW
Washington, DC 20508

Dear Secretary Raimondo and Ambassador Tai:

We are concerned about recent trends in antitrust enforcement by foreign countries against American companies and the threat these trends pose to comity and the stability of relations between the United States and our allies abroad.

The last year has seen a marked increase in U.S.-based companies doing business principally in the United States being mired in investigations and enforcement actions by foreign antitrust agencies, in many cases where the U.S. antitrust agencies determined the transactions passed competition muster, and in some cases did not even warrant investigation. Three stark examples from recent days underscore the urgency of these concerns:

In September 2022, the European Commission blocked U.S.-based Illumina's re-acquisition of its spinoff, U.S.-based Grail. Blocking this deal threatens to blunt U.S. leadership in innovation around multi-cancer early detection testing that lowers costs and facilitates equal and affordable access to such testing. While it's unclear whether Europe's aggressive action against the U.S. businesses may encourage similar action from the U.S. Federal Trade Commission (FTC), more clear is that the transaction poses little risk to competition in the U.S., as the FTC's own Administrative Law Judge held.[1] This represented the second time Illumina's acquisition of a U.S.-based company was blocked, wholesale, by a foreign competition agency, as the U.K. Competition and Markets Authority (CMA) in 2019 took the lead in stopping its acquisition of California-based PacBio, also rejecting any remedy short of a full block.[2]

[1] Administrative Law Judge Dismisses FTC's Challenge of Illumina's Proposed Acquisition of Cancer Detection Test Maker Grail, Federal Trade Commission, Sept. 12, 2022, available at https://www.ftc.gov/news-events/news/press-releases/2022/09/administrative-law-judge-dismisses-ftcs-challenge-illuminas-proposed-acquisition-cancer-detection.

[2] The CMA's October 2019 Provisional Findings are available at https://assets.publishing.service.gov.uk/media/5db1b98a40f0b609ba817d38/Illumina_Pacbio_-_ProvFindings.pdf. Months later, the FTC followed the

The CMA order, imposed on October 18, 2022, compelled Meta to spin off its recent acquisition of GIPHY. Meta, a U.S.-based company, acquired GIPHY, a U.S.-based company with zero revenues in the U.K., in 2020. Within weeks of announcing the acquisition, the CMA imposed an interim enforcement order blocking Meta from integrating GIPHY with any of its platforms and requiring Meta to seek approval for product launches and personnel changes—heavy-handed processes unheard of under U.S. merger review. Meanwhile the U.S. antitrust agencies showed little interest in the deal and have taken no action. The CMA's investigation concluded that Meta likely acquired GIPHY because it was one of very few suppliers of gifs to its products and because it lacked a revenue strategy and was at risk of exiting the market, leaving little competition. The CMA investigation noted that no other entity came forward with interest to acquire GIPHY.

This means that Meta's acquisition would have maintained competition, while the U.K.'s order that a U.S. company divest another U.S. company with no real presence in the U.K. may very well leave *less* competition—in the U.S., the U.K., and globally—in the relevant market, while destroying the creation of consumer value by two U.S. companies.[3]

The CMA's conduct against mergers among U.S. companies has demonstrated a striking lack of good faith, due process,[4] or economic principle. For example, in the GIPHY case the U.K.'s Competition Appeal Tribunal (CAT) admonished the CMA for infringing Meta's rights of defense by improperly withholding relevant information, including the facts that (1) one of Meta's largest competitors, Snap, Inc., purchased Gfycat, a close competitor of GIPHY; and (2) Snap placed a very low valuation on GIPHY's business.[5] The CAT also criticized the CMA's theory that the deal had to be blocked because GIPHY was practically uniquely situated to become the next social media giant.[6]

CMA's lead, also challenging the deal. Case summary at https://www.ftc.gov/legal-library/browse/cases-proceedings/1910035-illumina-incpacific-biosciences-california-inc-matter.

[3] Even commentators and academics in the U.K. have concerns about the CMA's enforcement policies on the U.K.'s investment ecosystem and the competitiveness of the U.K.'s digital sector. See, e.g., Devin Reilly, D. Daniel Sokol, and David Toniatti, "Risk and Repeat: How the Venture Capital Ecosystem Drives Entrepreneurship and Innovation," Oxford Business Law Blog, Jan. 12, 2022, available at https://blogs.law.ox.ac.uk/business-law-blog/blog/2022/01/risk-and-repeat-how-venture-capital-ecosystem-drives-entrepreneurship; Gary Dushnitsky, "Venture capital: an ecosystem under threat?," Think at London Business School, Nov. 24, 2021, available at https://www.london.edu/think/iepc-venture-capital-an-ecosystem-under-threat.

[4] Companies cannot challenge the merits of CMA rulings on appeal, but under a "judicial review" standard only ask whether the CMA acted irrationally or illegally.

[5] In addition to being unfair, the CMA's actions in this respect are in tension with the obligations that the United States has established in recent U.S. free trade agreements. *See, e.g.,* USMCA, Art. 21.2 (Procedural Fairness in Competition Law Enforcement).

[6] The CAT found that the CMA's selective disclosure was "difficult to defend and prima facie undermines the entirety of the Decision." 2022 CAT 26 at 88, 97, available at https://www.catribunal.org.uk/sites/default/files/2022-06/20220614_1429_Judgment_FINAL%20%5B2022%5D%20CAT%2026.pdf.

These cases illustrate a troubling trend of foreign jurisdictions using competition policy not to further the principles of free enterprise and market economies, but rather to achieve political and industrial policy goals, often at the expense of U.S. companies and broader U.S. interests. This includes policies such as the EU's Digital Markets Act, which departs from internationally established competition principles and targets only U.S.-based tech firms, as the Biden Administration has recognized.[7] Making matters worse, these interventions may be inflicting undue influence on U.S. agencies, who have expressed concerns about being perceived as falling behind their foreign counterparts,[8] while companies legitimately worry that U.S. leadership in merger policy is being ceded to jurisdictions with restrictive policies tailored against U.S. innovation and competitiveness.[9]

In light of the foregoing, we believe USTR and Commerce should explore all available tools to deter foreign governments from pursuing policies or actions that target, on spurious grounds, U.S. businesses in industries where the United States is a global leader. For example, such actions may merit investigation under Section 301 of the Trade Act of 1974, which authorizes the Office of the U.S. Trade Representative to investigate foreign government measures that are "unjustifiable" or "unreasonable" and "burden or restrict U.S. commerce." We further request that you assess whether USTR or Commerce can address such practices under existing authority, or if additional authority may be needed to ensure American economic sovereignty and security.
Sincerely,

Jeff Duncan
Member of Congress

Michael Guest
Member of Congress

---

[7] *See, e.g.,* Aurelien Portuese, "Biden Administration Rightly Speaks Out on Europe's DMA," ITIF, Dec. 13, 2021 (citing U.S. Secretary of Commerce Gina Raimondo's statement that the Biden Administration has "serious concerns" that the Digital Markets Act "will disproportionately impact U.S.-based tech firms and their ability to adequately serve EU customers and uphold security and privacy standards"), available at https://itif.org/publications/2021/12/13/biden-administration-rightly-speaks-out-europes-dma/.

[8] Lina Khan, Cristina Caffarra, Rupprecht Podszun, Pierre Régibeau, Mike Walker, Lina Khan : US antitrust takes big steps – How to read that in Europe?, Feb. 2021, Concurrences N° 1-2021, Art. N° 98402, ("[T]he US has been behind the curve, especially with regards to the European Commission, with CMA."); Clara Hendrickson, "After years of lagging behind the international community, will the US begin to rein in 'big tech'?", Brookings, June 6, 2019, available at https://www.brookings.edu/blog/techtank/2019/06/06/after-years-of-lagging-behind-the-international-community-will-the-u-s-begin-to-rein-in-big-tech/.

[9] *See, e.g.*, U.K. and E.U. actions blocking transactions among U.S. companies such as the McGraw-Hill and Cengage merger, which posed a threat to the dominance of U.K.-based Pearson plc and the Sabre/Farelogix merger blocked by the CMA but cleared in the U.S. Jonathan Rubin and Timothy LaComb, "End of an Era: The U.S. is No Longer the Authority Figure for Multinational Mergers," National Law Review, May 19, 2020.

FEDERAL TRADE COMMISSION
PROTECTING AMERICA'S CONSUMERS

Business Blog

Keep your AI claims in check

By: Michael Atleson, Attorney, FTC Division of Advertising Practices | February 27, 2023

A creature is formed of clay. A puppet becomes a boy. A monster rises in a lab. A computer takes over a spaceship. And all manner of robots serve or control us. For generations we've told ourselves stories, using themes of magic and science, about inanimate things that we bring to life or imbue with power beyond human capacity. Is it any wonder that we can be primed to accept what marketers say about new tools and devices that supposedly reflect the abilities and benefits of artificial intelligence (AI)?

And what exactly is "artificial intelligence" anyway? It's an ambiguous term with many possible definitions. It often refers to a variety of technological tools and techniques that use computation to perform tasks such as predictions, decisions, or recommendations. But one thing is for sure: it's a marketing term. Right now it's a hot one. And at the FTC, one thing we know about hot marketing terms is that some advertisers won't be able to stop themselves from overusing and abusing them.

AI hype is playing out today across many products, from toys to cars to chatbots and a lot of things in between. Breathless media accounts don't help, but it starts with the companies that do the developing and selling. We've already warned businesses to avoid using automated tools that have biased or discriminatory impacts. But the fact is that some products with AI claims might not even work as advertised in the first place. In some cases, this lack of efficacy may exist regardless of what other harm the products might cause. Marketers should know that — for FTC enforcement purposes — false or unsubstantiated claims about a product's efficacy are our bread and butter.

When you talk about AI in your advertising, the FTC may be wondering, among other things:

Are you exaggerating what your AI product can do? Or even claiming it can do something beyond the current capability of any AI or automated technology? For example, we're not yet living in the realm of science fiction, where computers can generally make trustworthy predictions of human behavior. Your performance claims would be deceptive if they lack scientific support or if they apply only to certain types of users or under certain conditions.

Are you promising that your AI product does something better than a non-AI product? It's not uncommon for advertisers to say that some new-fangled technology makes their product better – perhaps to justify a higher price

or influence labor decisions. You need adequate proof for that kind of comparative claim, too, and if such proof is impossible to get, then don't make the claim.

Are you aware of the risks? You need to know about the reasonably foreseeable risks and impact of your AI product before putting it on the market. If something goes wrong – maybe it fails or yields biased results – you can't just blame a third-party developer of the technology. And you can't say you're not responsible because that technology is a "black box" you can't understand or didn't know how to test.

Does the product actually use AI at all? If you think you can get away with baseless claims that your product is AI-enabled, think again. In an investigation, FTC technologists and others can look under the hood and analyze other materials to see if what's inside matches up with your claims. Before labeling your product as AI-powered, note also that merely using an AI tool in the development process is not the same as a product having AI in it.

This message is not new. Advertisers should take another look at our earlier AI guidance, which focused on fairness and equity but also said, clearly, not to overpromise what your algorithm or AI-based tool can deliver. Whatever it can or can't do, AI is important, and so are the claims you make about it. You don't need a machine to predict what the FTC might do when those claims are unsupported.

Tags: Consumer Protection | Bureau of Consumer Protection | Human-computer interaction | Technology | Advertising and Marketing | Advertising and Marketing Basics

October 13, 2022

The Honorable Lina Khan
Chair
Federal Trade Commission
600 Pennsylvania Avenue, NW
Washington, DC 20580

Dear Chairwoman Khan:

We are writing in support of the Commission's Franchise Rule, which is currently under decennial review. We believe that the FTC Franchise Rule has helped empower current and prospective franchise owners by requiring clear and consistent disclosure of information at the outset of all franchise relationships, and thus it has fostered an economic landscape that has led to 792,014 establishments currently using the franchise business format in the U.S. For these reasons, we believe the Franchise Rule should be renewed in its current form.

As you know, since 1978 the Franchise Rule has been the primary federal regulation governing the franchise sector. The Rule affords prospective franchise owners information they need to weigh the risks and benefits of a business investment by requiring franchisors to provide all potential franchisees with a disclosure document containing 23 specific items of information about the offered franchise and the overall franchise system. The FTC Franchise Rule was updated more than a decade ago following a consensus-based process that delivered clear guidelines for franchisors to follow and transparent information for prospective franchise owners before making an investment.

The Franchise Rule has successfully created a path to entrepreneurship for business owners of all backgrounds and enabled these owners to create wealth in communities across the nation. Franchise businesses are owned in greater percentage (30.8 percent) by People of Color than nonfranchised businesses (18.8 percent).[1] Sales in franchised businesses exceed non-franchised businesses across all demographic cuts, including gender and race. For example, Black-owned franchise firms generate 2.2 times as much in sales compared to Black-owned non-franchise businesses, on average.[2] Underscoring the distinctive opportunity provided only by franchising, 32% of franchise owners reported they would not own a business if they were not franchisees. This proportion is even greater among both female owners and owners for whom a franchise was their first business (39%). When applied to the total number of franchise firms, this would be equivalent to a loss of nearly 223,000 establishments that employ some 1.8 million workers if franchising was not an option.

Importantly, the current Rule has governed franchise small business creation during the economic recovery following the onset of the COVID-19 pandemic. According to the 2022 Franchising Economic Outlook, following business shutdowns in 2020, total franchise establishments increased by 2.8% to 774,965 in 2021, a net gain of 21,195 compared to 2020. Last year, franchises yielded $788 billion in overall economic output and employed more than 8 million people.[3] Today as the franchising community emerges from the pandemic, franchisee satisfaction has never been higher. In fact, 88% of franchisees reportedly enjoy operating their business and 86% enjoy being part of their franchise organizations.[4]

---

[1] *Franchised Business Ownership by Minority and Gender Groups. IFA Foundation (2018).*
[2] *The Value of Franchising. Oxford Economics (2021).*
[3] *Franchise Economic Outlook. International Franchise Association (2022).*
[4] *Franchise Industry Report. Franchise Business Review (2022).*

For these reasons, we strongly affirm a continuing need for the Franchise Rule that supports small businesses operating in our states.

Sincerely,

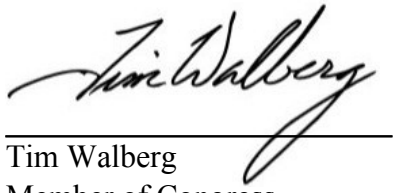
Tom O'Halleran
Member of Congress

Brett Guthrie
Member of Congress

Scott H. Peters
Member of Congress

Debbie Lesko
Member of Congress

Troy Carter
Member of Congress



Tim Walberg
Member of Congress

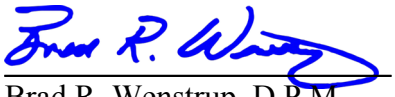
Bill Johnson
Member of Congress

James Comer
Member of Congress

Cliff Bentz
Member of Congress

Steve Chabot
Member of Congress

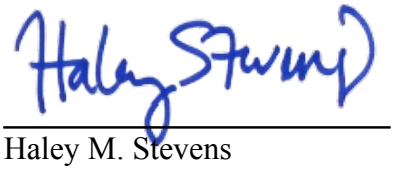
Lloyd Smucker
Member of Congress



Brad R. Wenstrup, D.P.M.
Member of Congress

Dean Phillips
Member of Congress

Ted Budd
Member of Congress

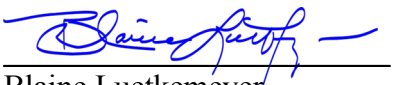


Haley M. Stevens
Member of Congress

John Joyce, M.D.
Member of Congress

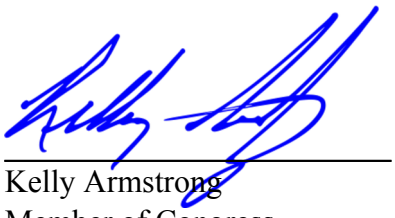
Daniel Webster
Member of Congress

Dina Titus
Member of Congress



Blaine Luetkemeyer
Member of Congress

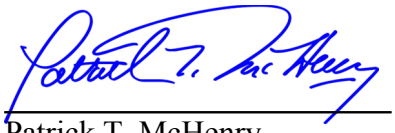
Mike Bost
Member of Congress



Kelly Armstrong
Member of Congress

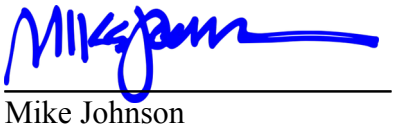
Rick W. Allen
Member of Congress

Tracey Mann
Member of Congress



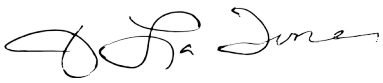
Patrick T. McHenry
Member of Congress

David Kustoff
Member of Congress

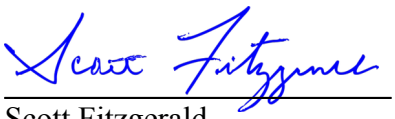


Mike Johnson
Member of Congress

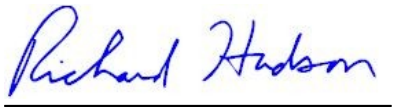
Ashley Hinson
Member of Congress



Jake LaTurner
Member of Congress

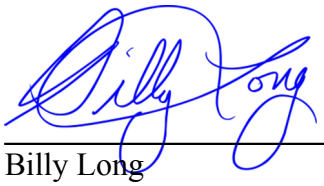


Scott Fitzgerald
Member of Congress

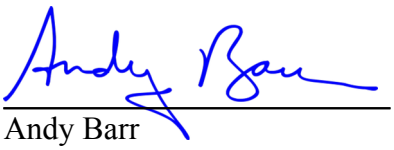


Richard Hudson
Member of Congress

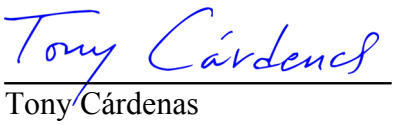
Neal P. Dunn, M.D.
Member of Congress



Billy Long
Member of Congress

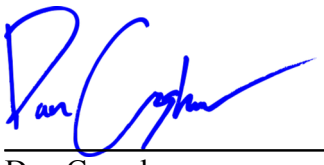


Andy Barr
Member of Congress



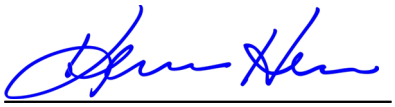
Tony Cárdenas
Member of Congress

Lisa Blunt Rochester
Member of Congress

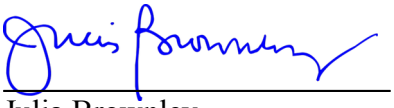


Dan Crenshaw
Member of Congress

Larry Bucshon, M.D.
Member of Congress

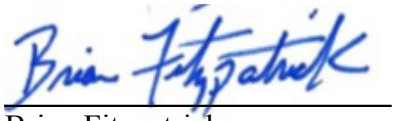


Kevin Hern
Member of Congress



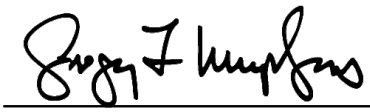
Julia Brownley
Member of Congress

A. Drew Ferguson IV
Member of Congress

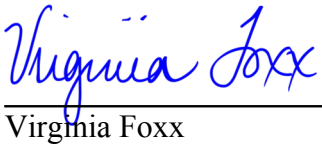


Brian Fitzpatrick
Member of Congress

Diana Harshbarger
Member of Congress



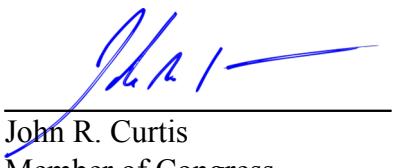
Gregory F. Murphy, M.D.
Member of Congress



Virginia Foxx
Member of Congress

Austin Scott
Member of Congress

Kurt Schrader
Member of Congress



John R. Curtis
Member of Congress

Troy Balderson
Member of Congress

Elise M. Stefanik
Member of Congress

Mike Flood
Member of Congress

Mariannette Miller-Meeks, M.D.
Member of Congress

Jerry L. Carl
Member of Congress

Chris Pappas
Member of Congress

Don Bacon
Member of Congress

Brad Finstad
Member of Congress

Chrissy Houlahan
Member of Congress

Darrell Issa
Member of Congress

Jake Ellzey
Member of Congress

Earl L. "Buddy" Carter
Member of Congress

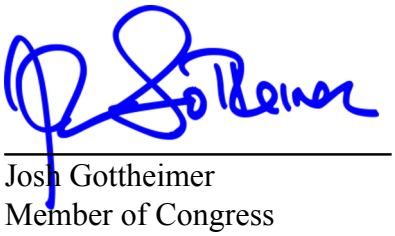
Ralph Norman
Member of Congress

A. Donald McEachin
Member of Congress

Ron Estes
Member of Congress

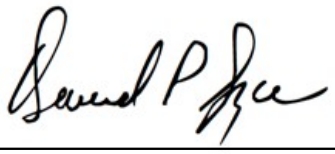
David G. Valadao
Member of Congress

Pete Stauber
Member of Congress



Josh Gottheimer
Member of Congress

Young Kim
Member of Congress



David P. Joyce
Member of Congress

Robert E. Latta
Member of Congress

U.S. Chamber of Commerce

1615 H Street, NW
Washington, DC 20062-2000
uschamber.com

April 18, 2023

The Honorable Cathy McMorris Rodgers
Chair
Committee on Energy and Commerce
Washington, DC 20515

The Honorable Frank Pallone
Ranking Member
Committee on Energy and Commerce
Washington, DC 20515

Dear Chair McMorris Rodgers and Ranking Member Pallone:

The U.S. Chamber of Commerce appreciates the House Committee on Energy and Commerce conducting vigorous oversight of the Federal Trade Commission (FTC). We have grave concerns about the leadership of Lina Khan at the FTC, and about the state of due process and accountability at the Commission.

The allegations made by Commissioner Christine Wilson that led to her principled resignation, that her fellow Commissioners redacted her dissent in a matter with "no purpose but to protect Ms. Khan from embarrassment,"[1] are disturbing and if confirmed, reflect an even broader trend of FTC impropriety. Nonetheless, despite these serious allegations and an extensive record of FTC mismanagement and regulatory overreach, the Biden Administration's Fiscal Year 2024 budget request included a $160,000,000 increase for FTC.

Beyond the important oversight by the Committee, we strongly urge the full Congress and other Committees to conduct vigorous oversight of the FTC's activities and practices. With respect to the power of the purse, we urge Congress to reject any budget increase for the FTC for FY 2024 consider including riders that provide common sense guardrails for the agency's actions.

The FTC's Unauthorized Regulatory Campaign

Despite the Supreme Court unanimously finding that the Commission had exceeded its enforcement authority,[2] the agency has unilaterally granted itself authority outside those properly delegated by Congress.

Beginning in June 2021 the FTC under Chair Khan upended decades long, bipartisan practice by consolidating power to the Chair in Magnuson-Moss Rulemakings in consumer protection matters and ending its application of the consumer welfare standard in competition

[1] https://www.wsj.com/articles/why-im-resigning-from-the-ftc-commissioner-ftc-lina-khan-regulation-rule-violation-antitrust-339f115d

[2] *See* Federal Trade Commission v. AMG Capital Management,. 593 U.S. ___ (2019).

matters.[3] These actions set the stage for the Commission to make end runs around Congressional intent in both rulemakings and enforcement.

Under Chair Khan's leadership, the agency has undertaken an unprecedented number of rulemakings, assuming authority to regulate across industry sectors on issues as diverse as like earnings claims and endorsements, unfair or deceptive fees, data privacy and artificial intelligence, and auto dealer sales.

The Commission is clearly claiming authority not granted to them by Congress by exploring whether to micromanage the fees companies[4] can charge and data privacy.[5] These rulemakings are troubling in light of the decision by the Supreme Court in *West Virginia v. EPA* in which the Court held that agencies must have clear grants of authority when regulating a matter of economic and political significance. Here, Congress has not passed legislation as noted in the President's State of the Union Address last February.[6] Former Commissioner Noah Phillips put it best when he stated about the FTC's privacy rulemaking, "What the ANPR does accomplish is to recast the Commission as a legislature, with virtually limitless rulemaking authority where personal data are concerned."

Not only has the Commission exceeded its consumer protection authority, but the Commission has also determined that it now regulates employer relations in its proposed ban on non-compete clauses under what it claims is authority to make rules against unfair methods of competition. Congress has never granted the authority for the FTC to make competition rules, but only consumer protection regulations under its unfair and deceptive practices authority.

Broader Agency Mismanagement

While the Commission attempts to effectively micromanage the U.S. economy on shaky authority, on a smaller level it has been mismanaged by leadership over the last two years. For example, the FTC's Office of Inspector General found that the agency used unpaid experts and consultants in ways that lacked transparency and comprehensive controls. The agency failed to ensure that these experts and consultants were not performing inherently governmental functions, introducing "operational, legal, compliance, security, and reputational risk" to the agency.[7]

---

[3] *See* Dissent of Commissioner Wilson (July 1, 2021) *available at* https://www.ftc.gov/system/files/documents/public_statements/1591554/p210100wilsoncommnmeetingdissent.pdf.

[4] https://americaninnovators.com/wp-content/uploads/2023/02/230208_Comments_JunkFeesANPR_FTC.pdf

[5] https://www.uschamber.com/assets/documents/221121_Comments_CommercialSurveillanceDataSecurity_FTC.pdf

[6] https://www.whitehouse.gov/briefing-room/speeches-remarks/2023/02/07/remarks-of-president-joe-biden-state-of-the-union-address-as-prepared-for-delivery/

[7] https://www.ftc.gov/system/files/ftc_gov/pdf/2022-08-01_OIGauditreport_unpaidconsultants_FINAL.pdf?utm_source=sfmc&utm_medium=email&utm_campaign=&utm_term=Comp+EO+Update+October&utm_content=10/4/2022

Surveys reveal that morale among FTC staff has plummeted since Chair Khan took over. Among other results, 28.8% of respondents "disagree or strongly disagree" that the agency's leadership "maintain high standards of honesty and integrity." In written testimony, a commissioner complains that "procedural irregularities" have precluded robust dialogue within the agency, including "Muzzling staff internally and externally."[8]

And finally, the Commission allowed the use of "Zombie Votes" that enabled current CFPR Chair Rohit Chopra to effectively vote on matters before the FTC even when he was no longer a commissioner.

Lack of Agency Independence

Independent agencies like the FTC have been given deference by courts because of their supposed independent expertise. Unfortunately, Chair Khan, when opining on the President's Executive Order on Competition specifically tasking FTC, celebrated the Order, stating that the Order "recognizes the whole-of-government approach needed to urgently tackle unhealthy concentration and unfair methods of competition across the economy" and commits to expanding interagency collaboration. Since Congress has purposely developed independent agencies to make judgements outside the influence of the executive branch, such statements by the Chair about the Order as well as the use of common and previously unused terminology in Executive Orders, the White House A.I. Bill of Rights, and the "commercial surveillance" and "junk fees" rulemakings raise significant questions about whether FTC should be granted judicial deference.

The Chamber appreciates your concern in this matter and stands ready to work with you to ensure agencies are accountable and transparent to the American people. We urge Congress to pursue necessary oversight, including through the appropriations process, to ensure accountability at the FTC.

Sincerely,

Neil L. Bradley
Executive Vice President, Chief Policy Officer,
and Head of Strategic Advocacy
U.S. Chamber of Commerce

cc: Members of the House Committee on Energy and Commerce

[8] https://twitter.com/CSWilsonFTC/status/1519786949476761601

Federal Trade Commission
600 Pennsylvania Ave., NW
Washington, D.C. 20580

September 20, 2022

Dear Chair Khan and Commissioners Bedoya, Phillips, Slaughter, and Wilson,

As alumni of the Federal Trade Commission, we have devoted significant portions of our careers to protecting consumers and competition. We continue to care deeply about the agency and its mission. For instance, many of us have publicly encouraged Congress to grant the agency more funding and clearer remedial authority. Many of us support the FTC's current initiatives, including efforts to protect consumer privacy, and in fact many of us have long advocated for more vigorous enforcement of the antitrust laws.

In this spirit, we write to encourage you to commit to operate within the FTC's traditional norms and statutory bounds. Over the past several decades, the FTC has functioned with a large degree of consensus, seeking input from staff, stakeholders (including the private sector), and all commissioners. The FTC generally operated within the limits of its authority. We are concerned, however, that the agency seems to be moving away from some of these norms and that these changes may undermine the agency's credibility to enforce the law and to protect consumers. In the worst case, with ongoing scrutiny of administrative agencies, departure from these norms could imperil long-term support for the agency itself.

Nevertheless, the FTC can resume its historic and successful operations through a few simple steps: incorporate the input of staff, stakeholders, and all commissioners; recognize that, particularly given recent court decisions, administrative agencies must operate within their statutory bounds; and, finally, recommit to the agency's traditional enforcement tools and competition advocacy. Through these steps, the agency could fulfill its mission and leave a lasting and positive legacy.

A. Lead Through Consensus

Over the past several decades, the FTC has functioned with a large degree of consensus among the commissioners and with the career staff. Unfortunately, the latest results of the Federal Employee Viewpoint Survey show notable changes in the staff's opinions and morale.[1] The FTC has also seen an exodus of senior staff and a significant concentration of authority.

Fortunately, the remedy is simple. We encourage a return to the tradition of meaningful consultation among the agency's staff, stakeholders, and all commissioners. Based on our

[1] Compare https://www.opm.gov/fevs/reports/data-reports/data-reports/report-by-agency/2020/2020-agency-report.pdf with https://www.opm.gov/fevs/reports/data-reports/data-reports/report-by-agency/2021/2021-agency-report.pdf.

experience, agency personnel fully support the agency's mission, and with few exceptions, the private sector wants to comply fully with the law.

B. Operate Within Statutory Bounds and Norms

In recent decisions, the courts have limited the ability of administrative agencies to exercise authority without a clear basis in statutory language. For instance, in *AMG Capital Management LLC v. FTC*, the Supreme Court unanimously held that the FTC lacks statutory authority to seek equitable monetary relief in federal court under Section 13(b) of the FTC Act. Similarly, in *West Virginia v. Environmental Protection Agency*, the Supreme Court, invoking the "major questions doctrine," held that the Clean Air Act did not grant the EPA authority to devise carbon emission caps. Finally, in *Jarkesy v. Securities and Exchange Commission*, the Fifth Circuit held that Congress unconstitutionally delegated legislative power to another multimember agency.

Against this backdrop, the FTC should ensure that its actions have a firm basis in both the statutory text and past practice. The FTC should *not* base a significant action, such as a rulemaking, on a thin statutory reed that lacks a consistent history of use. Any overreaching activities, not clearly grounded in statute and precedent, could damage long-term support for the agency and, at a minimum, could distract from the agency's core mission of protecting consumers. Already, various courts and commentators have called into question the ongoing validity of *Humphrey's Executor v. United States*, which upheld the FTC's design in part due to its nonpartisan nature.[2] *Axon v. FTC*, currently pending in the Supreme Court, raises some of these same issues.

Similarly, Congress itself could revisit the agency's ongoing authority. In the 1980s, in response to aggressive rulemakings that led some to deem the FTC the "national nanny,"[3] Congress cabined the FTC's discretion.[4] Today, Congress could easily respond to agency overreach by reducing the FTC's funding, limiting its functions, or even dismembering the agency entirely.

As an alternate approach, we encourage the FTC to seek and rely upon specific statutory authority granted by Congress. Beginning with the Pay-Per-Call rulemaking in the 1990s, the Commission first used a case-by-case approach to build a record demonstrating industry or technology-specific law violations and harms to consumers, and *then* took this record to Congress to support a request for specific statutory authority pursuant to Section 553 of the Administrative Procedure Act. This approach resulted in such successful rulemaking efforts as the 900 Pay-Per-Call, Telemarketing Sales, Do- Not-Call, and CANSPAM rules.

Of course, we agree that it is entirely appropriate for the Commission to develop the contours of existing law by developing and bringing meritorious cases that show evidence of harm to consumers. If the Commission still believes that it is necessary and appropriate to make novel use of its rulemaking authority and expertise, we recommend that it follow the same process it

[2] *E.g.*, *PHH Corp. v. Consumer Financial Protection Bureau*, No. 15-1177, (D.C. Cir. 2018) (Kavanaugh, J., dissenting).
[3] See https://www.wsj.com/articles/return-of-the-national-nanny-ftc-activists-rulemaking-regulation-banning-mandates-illegal-11653596958.
[4] *E.g.*, https://library.cqpress.com/cqalmanac/document.php?id=cqal82-1164529.

has used to great success and public benefit: first develop an enforcement record demonstrating the need for rulemaking, and then ask Congress for specific statutory authority to use Section 553 rulemaking to address the specific problems that have been identified in its enforcement work.

C. Recommit to Vigorous Enforcement Through the Agency's Traditional Tools

Rather than sail into unchartered legal waters, the FTC should embrace its tried-and-true methods of fulfilling its mission. Most obviously, the agency should develop meritorious cases, grounded in empirical economics and demonstrable harm to consumers, and allow the courts to evaluate those cases. Likewise, the agency should review proposed mergers in a timely, predictable, and transparent manner. Finally, the FTC should continue to study ever-changing markets fairly and objectively, without presupposition.

***

We hope that you will review this letter in the spirit in which it was written. All of us stand ready to work with you to help the agency fulfill its mission, now and for the future.

Signed,

Alumni of the FTC[5]

Asheesh Agarwal
Former Assistant Director
Office of Policy Planning

Theodore A. Gebhard
Former FTC Senior Attorney
Office of Policy & Evaluation

John Delacourt
Former Chief Antitrust Counsel
Office of Policy Planning

Bilal Sayyed
Former Director
Office of Policy Planning

Todd Zywicki
Former Director
Office of Policy Planning

[5] Every signatory is signing in his or her individual capacity, rather than on behalf of an organization.

Alden Abbott
Former General Counsel
Office of General Counsel
Senior Research Fellow, Mercatus Center at George Mason University

Dan Caprio
Former Attorney Advisor
Office of Commissioner Orson Swindle

Eileen Harrington
Executive Director (2012-2013)
Acting Director, Bureau of Consumer Protection (2009)
Deputy Director, Bureau of Consumer Protection (2004-2009)
Associate Director for Marketing Practices, BCP (1992-2004)

Liad Wagman
Former Senior Economic and Technology Advisor
Office of Policy Planning

Betsy Broder
Former Counsel for International Consumer Protection
Office of International Affairs

Neil Chilson
Former Chief Technologist
Federal Trade Commission

Tom Pahl
Former Acting Director
Bureau of Consumer Protection

Ginger Zhe Jin
Former Director
Bureau of Economics

Allen Hile
BCP Special Counsel for Regulatory Issues (2009-2012)
Assistant Director, Division of Marketing Practices (1994-2008)

David Torok
Associate Director Division of Consumer Response and Operations (formerly Division of Planning and Information) (2005-2016)
Assistant Director Division of Marketing Practices (2004-2005)
Initial National Do Not Call Registry Program Manager (2001-2003)

Julie Carlson
Economist, Bureau of Economics (2007-2021)
Advisor to the Director, Bureau of Economics (2021)
Economist Advisor to Chairman Simons (2020)
Economist Advisor to Commissioner Kovacic (2011)

AUDIT OF THE FEDERAL TRADE COMMISSION'S UNPAID CONSULTANT AND EXPERT PROGRAM

Office of Inspector General
Federal Trade Commission

OIG Report No. A-22-06
August 1, 2022

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Office of Inspector General

August 1, 2022

MEMORANDUM

FROM: Andrew Katsaros
Inspector General

TO: David B Robbins
Executive Director

SUBJECT: Audit of the Federal Trade Commission's Unpaid Consultant and Expert Program

The Office of Inspector General (OIG) conducted a performance audit to determine whether the FTC's program used to hire and oversee unpaid consultants and experts is managed in accordance with federal and agency requirements.

Our audit found that, without a deliberate control structure and stronger mitigation posture, the agency is vulnerable to a variety of risks. More specifically, our audit found the following: (1) the FTC's unpaid consultant and expert program lacks a comprehensive system of controls and (2) the FTC identifies, recruits, and selects unpaid consultants and experts without uniformity and transparency across all agency stakeholders.

The FTC's response to the draft report's findings and recommendations is included as appendix C. The response reflects that the FTC concurred with the report's recommendations. Within 60 calendar days, please submit to us an action plan that addresses the recommendations in this report.

A public version of this report will be posted on the OIG's website pursuant to sections 4 and 8M of the Inspector General Act of 1978, as amended (5 U.S.C. App., §§ 4 and 8M).

The OIG greatly appreciates the cooperation and courtesies extended to us by the Office of the Executive Director throughout the audit.

If you have any questions regarding this report, please contact me at (202) 326-3527.

Audit of the Federal Trade Commission's Unpaid Consultant and Expert Program

Office of Inspector General

August 1, 2022
Report No. A-22-06

In Summary

Why We Performed This Audit

The audit objective was to determine whether the FTC's program used to hire and oversee unpaid consultants and experts is managed in accordance with federal and agency requirements.

The FTC leverages capabilities and expertise—not otherwise found within the agency's federal workforce—from additional human capital gained through a variety of paid and unpaid positions.

Our assessment of the risks inherent in the onboarding and integration of each of these employee classes led us to focus specifically on the FTC's deployment of unpaid consultant and experts, which we have done for the period covering October 1, 2020, through March 31, 2022.

When the FTC enters into agreements with unpaid consultants and experts, the agency introduces operational, legal, compliance, security, and reputational risk. Our audit found that, without a deliberate control structure and stronger mitigation posture, the agency is vulnerable to a variety of risks.

What We Found

Our audit found the following:

I. *The FTC's unpaid consultant and expert program lacks a comprehensive system of controls*. We found that the FTC has limited controls over unpaid consultants' and experts' involvement in inherently governmental functions. More specifically, it has not developed and adopted a formal process, informed by policy and procedures, to capture the scope of unpaid experts' or consultants' work—including clear restrictions on the scope of work (i.e., inherently governmental functions) to be conducted. We also found that the agency has not sufficiently developed criteria for its unpaid consultants and experts. It maintains these individuals' justifications and approvals, including term end dates and general activities that these individuals will participate in during their temporary stay with the agency. However, they do not contain sufficient caveats and restrictions that would limit the agency's exposure to a variety of risks.

II. *The FTC identifies, recruits, and selects unpaid consultants and experts without uniformity and transparency across all agency stakeholders*. The processes by which the FTC onboards and deploys its unpaid experts and consultants pose a number of risks. Currently, the identification, recruitment, and selection of unpaid consultants and experts is conducted on an ad hoc basis—which has contributed to confusion about where these consultants are located organizationally, the goals and scope of their work, and their objectives.

What We Recommend

Recommendation 1
We recommend that the FTC Executive Director, in coordination with bureau directors, develop internal policy or guidance requiring documenting unpaid consultants' and experts' scope of work—including guidance on allowable and prohibited activities and a process for communicating the scope of work with candidates prior to their time with the FTC.

Recommendation 2
We recommend that the FTC Executive Director, in coordination with office and bureau directors, establish individual employment agreements for each unpaid consultant and expert, delineating roles and restrictions for each position.

Recommendation 3
We recommend that the Executive Director, in coordination with bureau directors, develop and disseminate unpaid consultant and expert program policies and procedures for identifying and documenting position needs and standardizing recruitment and selection.

FTC management concurred with our report recommendations.

CONTENTS

AUDIT RESULTS SUMMARY

We conducted a performance audit to determine whether the Federal Trade Commission's (FTC's) program used to hire and oversee unpaid consultants and experts is managed in accordance with federal and agency requirements. The FTC leverages capabilities and expertise—not otherwise found within the agency's federal workforce—from additional human capital gained through a variety of paid and *unpaid positions*.[1] In addition to unpaid consultants and experts, these positions include details, Presidential Innovation Fellows (PIFs), Presidential Management Fellows (PMFs), and Intergovernmental Personnel Act (IPA) personnel from non-federal entities. Each of these positions is described in more detail in the next section. Our assessment of the risks[2] inherent in the onboarding and integration of each of these employee classes led us to focus specifically on the FTC's deployment of unpaid consultant and experts, which we have done for the period covering October 1, 2020, through March 31, 2022.

(For further detail on our objective, scope, and methodology, see appendix A. See appendix B for a list of acronyms and abbreviations used in this report.)

When the FTC enters into agreements with unpaid consultants and experts, the agency introduces operational, legal, compliance, security, and reputational risk. Our audit found that, without a deliberate control structure and stronger mitigation posture, the agency is vulnerable to a variety of risks. More specifically, our audit found the following:

I. the FTC's unpaid consultant and expert program lacks a comprehensive system of controls and

II. the FTC identifies, recruits, and selects unpaid consultants and experts without uniformity and transparency across all agency stakeholders.

The report contains three recommendations for strengthening the controls and overall efficiency of the FTC's unpaid consultants and experts program. In a written response to this report, FTC management concurred with all three recommendations and described planned actions that were responsive. The FTC response to our report is included in its entirety in appendix C.

---

[1] *Unpaid positions* include salaries that the FTC does not pay. Based on our research into and documentation of each type of unpaid position that the FTC uses, we determined that their salaries are paid by the home employer or agency (in the case of PIFs, the home agency is the General Services Administration; in the case of PMFs, the home agency is the U.S. Office of Personnel Management).

[2] Office of Management and Budget (OMB) Circular No. A-11—issued to help agencies in preparing, submitting, and executing their federal budgets—defines *risk* as the effect of uncertainty on objectives. Agencies must analyze risk in relation to their achievement of appropriate operational objectives.

WHY WE PERFORMED THIS AUDIT

Over the course of multiple administrations, the FTC has augmented its staff with several types of other paid and unpaid positions, including the following:

- *Interagency Details*[3]—the temporary assignment of federal employees from different agencies for specified periods (after which the employees return to regular duties at their original agencies)

- *Presidential Innovation Fellows (PIFs)*[4]—technologists, designers, and strategists who join a 12-month federal program (renewable for a second 12 months) administered by the General Services Administration (GSA) to work on innovation projects across federal agencies

- *Presidential Management Fellows (PMFs)*[5]—advanced-degree candidates in a federal government leadership development program, starting at an entry level, for a 2-year excepted service appointment

- *Intergovernmental Personnel Act of 1970*[6] *(IPA) personnel*—staff temporarily assigned (generally less than 2 years) between the federal government and state and local governments, colleges and universities, Indian tribal governments, federally funded research and development centers, and other eligible organizations

- *Consultants* and *experts*[7]—in the former case, consultants provide valuable and pertinent advice drawn from broad administrative, professional, or technical knowledge or experience; in the latter case, experts are specially qualified by education and experience to be authorities, or unusually competent and skilled, in a professional, scientific, or technical field; in both cases, the agency may procure by contract the temporary (not in excess of 2 years total) or intermittent services appointments on a strictly intermittent basis, for no more than 1 initial year (who may be reappointed for no more than 1 additional year)

The FTC has deployed unpaid consultants and experts at an increasing rate, including adding 9 such positions starting in FY 2021 through March 2022 (versus 2[8] for FYs 2019–2020

---

[3] *See* 5 U.S.C. §§ 3341; 31 U.S.C. §§ 1301, 1535–36; 5 C.F.R. § 300.301.

[4] *See* 5 U.S.C. § 3171.

[5] Individuals who become *Presidential Management Fellows* (*PMFs*) join a federal government leadership development program that the Office of Personnel Management (OPM) oversees. To participate, an individual must have completed an advanced degree from a qualifying educational institution within the previous 2 years. OPM selects PMF finalists based on experience, accomplishments, and the results of a rigorous structured assessment process. For further details, *see* 5 C.F.R. Ch. 362.

[6] *See* 5 U.S.C. §§ 3371–75; *see also* 5 C.F.R. Ch. 334.

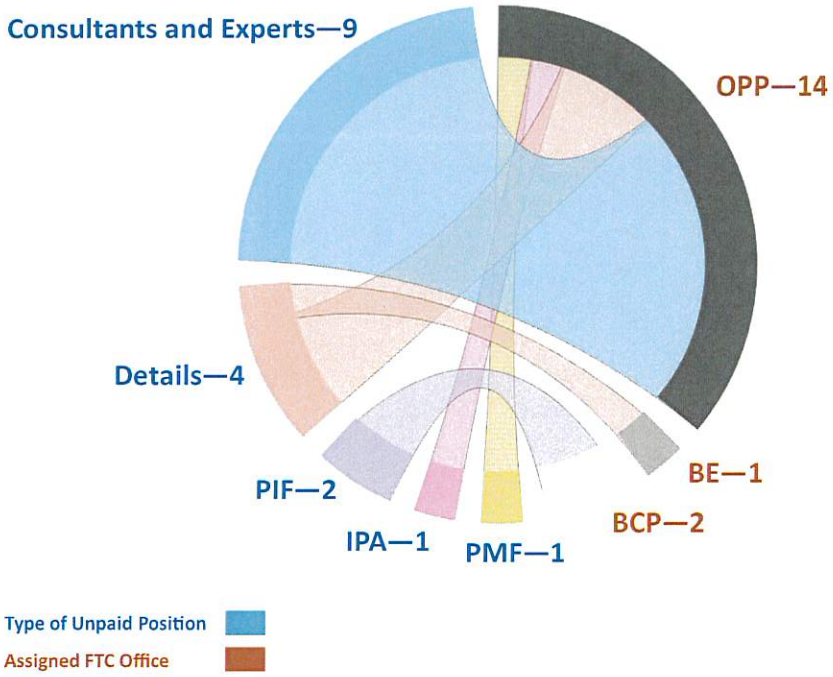
[7] *See* 5 U.S.C. § 3109; 5 C.F.R. Ch. 304.

[8] During this time period, the agency potentially onboarded additional consultants who had previously retired as FTC employees, then returned into unpaid positions.

combined). Our review of the risks associated with each of the positions above (see appendix A) led us to focus specifically on unpaid consultants and experts.[9]

The FTC's program of unpaid consultants and experts, while not unique, involve challenges that do not exist in a traditional federal employment arrangement. Our audit scope included the activities of all 9 unpaid consultants and experts assigned to the FTC's Office of Policy Planning (OPP) who onboarded during the period of our audit scope.[10] The agency has leveraged unpaid consultants and experts during previous administrations;[11] however, current FTC leadership has expanded their use, specifically in OPP, since 2021.

Figure 1: FTC Unpaid Positions (FY 2022)



[9] Agency management also reported that it had added to its risk portfolio a top item concerning the possibility of a major data breach committed by "third party experts, consultants, and contractors that do not have access to the FTC network."

[10] During the time of our fieldwork, the FTC onboarded 1 additional consultant/expert.

[11] The FTC has reported onboarding 2 unpaid consultants in FYs 2019–2020.

FINDINGS AND RECOMMENDATIONS

I. The FTC's Unpaid Consultant and Expert Program Lacks a Comprehensive System of Controls

A. The FTC Has Limited Controls Over Unpaid Consultants' and Experts' Involvement in Inherently Governmental Functions

5 U.S.C. § 3109 provides that "[w]hen authorized by an appropriation or other statute, the head of an agency may procure by contract the temporary (not in excess of 1 year) or intermittent services of experts or consultants."[12] The regulations implementing Section 3109 prohibit agencies from, among other things, appointing experts or consultants

> (3) [t]o perform managerial or supervisory work (although an expert may act as team leader or director of the specific project for which he/she is hired), to make final decisions on substantive policies, or to otherwise function in the agency chain of command (e.g., to approve financial transactions, personnel actions, etc.).
>
> (4) [t]o do work performed by the agency's regular employees.
>
> (5) [t]o fill in during staff shortages.[13]

Chapter 3, section 200, of the FTC *Administrative Manual* (last updated in March 2006) provides agency-specific guidance on "the proper appointment, use, and assignment of experts and consultants."[14] This guidance includes a section on the "Improper Use of Experts and Consultants"—prohibiting, among other types of work, that "of an ongoing nature more appropriately performed by permanent employees" and "of a policy and/or decision making or managerial nature."

The law, implementing regulations, and the *Administrative Manual* do not expand on what duties should be considered the ongoing work more appropriately performed by permanent employees serving a governmental function. However, the Federal Acquisition Regulation (FAR) and OMB guidance related to federal contractors define *inherently governmental functions* to include (a) determination of agency policy, such as determining the content and application of regulations; (b) determination of federal program priorities or budget requests; (c) selection or non-selection of individuals for federal government employment, including the interviewing of individuals for employment; and (d) direction and control of federal employees.[15]

---

[12] The FTC's recent appropriations have all provided for this authority.

[13] 5 C.F.R. § 304.103.

[14] This section of the manual cites the authority of OMB Circular A-120, *Guidelines for Advisory and Assistance Services* (January 1988) and 5 U.S.C. § 3109, *Employment of Experts and Consultants; Temporary or Intermittent*. OMB Circular A-120, however, was fully rescinded in 1994. 59 *Fed. Reg.* 789 (Jan. 6, 1994).

[15] See OMB, "Performance of Commercial Activities," Circular A-76 (August 4, 1983), and OMB OFPP, *Performance of Inherently Governmental and Critical Functions*, Policy Letter 11-01 (October 12, 2011).

OMB OFPP Policy Letter 11-01 further informs federal management that an "[i]nherently governmental function," as defined in section 5 of the Federal Activities Inventory Reform Act, Public Law 105–270, means a function that is so intimately related to the public interest as to require performance by federal government employees. In its appendix A, Policy Letter 11-01 lists examples of inherently governmental functions that include the following:

- the determination of agency policy, such as determining the content and application of regulations
- the determination of budget policy, guidance, and strategy
- the determination of federal program priorities or budget requests
- the selection or non-selection of individuals for federal government employment, including the interviewing of individuals for employment
- the direction and control of federal employees

Functions that unpaid consultants and experts can have involvement with may include activities that generally are not considered to be inherently governmental—but are closely associated with the performance of inherently governmental functions. In addition to examples contained in 5 C.F.R. § 304.103, examples provided by OMB's Office of Federal Procurement Policy (OFPP) Policy Letter 11-01, appendix B, identify permissible services in support of inherently governmental functions such as developing policies—including drafting documents as well as conducting analyses, feasibility studies, and strategy options.

The language included in several of the agency's unpaid consultants' and experts' justifications and approvals[16] approaches the proximity of a "policy" function reserved for federal employees only, as identified by OMB OFPP Policy Letter 11-01. Our fieldwork for this audit was not designed to determine whether unpaid consultant or experts were involved in activities prohibited by the federal policies and guidance identified herein, and we make no assertions on their involvement in those activities. Nevertheless, in its position justifications for these unpaid positions, the agency identifies the use of unpaid consultants and experts to perform such work. FTC management now has an opportunity to dedicate more attention to guarding against their expansion into inherently governmental functions.

In the context of complying with OMB guidance, FTC has not developed and adopted a formal process, informed by policy and procedures, to capture the scope of unpaid experts' or consultants' work. Based on our discussions with FTC officials and audit analysis, we found that many, if not all of the relationships with unpaid consultants and experts encompass a good deal of flexibility with respect to their potential use. Our

[16] FTC Form 189, *Justification and Approval of Employment of Expert/Consultant*, provides general instructions to managers from the originating office to record a "summary of duties" and "summary of qualifications" in sufficient detail.

review of the audit sample's justifications and approvals uncovered about half with language stating that the consultant or expert "will play an integral role in the Commission's strategic direction"—and most included language stating that they will have "wide latitude of responsibility" in relevant areas. Further, most indicated that the consultant or expert will be involved with policy, using language such as the following:

- "serve as a visionary leader on policy and strategic initiatives that directly and indirectly affect Commission technology policy and operation"
- "work together with staff and attorneys throughout the FTC to provide case support (investigation and litigation), policy research and development, competition and consumer advocacy, and, when needed, public outreach"
- "provide the Chair advice and analysis to inform FTC policy"

Such justification and approval language, found in many forms from our sample, provides such flexibility to management that it does not include clear restrictions on the scope of work (i.e., inherently governmental functions) to be conducted.

We found several vulnerabilities that amplified this risk. At the time of our audit fieldwork, the FTC had neither a system of controls nor guidance on consultants' and experts' scope of work—particularly, guidance identifying allowable and prohibited activities. 5 C.F.R. § 304.108 requires the following:

> (a) Each agency using 5 U.S.C. 3109 must establish and maintain a system of controls and oversight necessary to assure compliance with 5 U.S.C. 3109 and these regulations. The system must include—
>
> (1) Appropriate training and information procedures to ensure that officials and employees using the authority understand the statutory and regulatory requirements; and
>
> (2) Appropriate provision for review of expert and consultant appointments.

Additionally, we discovered that the agency does not fully communicate the scope of work with unpaid consultants and experts prior to their time with the agency. Lastly, the FTC does not have a process in place to identify and evaluate instances when an unpaid consultant's or expert's scope of work changes (i.e., including prohibited activities or office assignment)—and notify HCMO, the Office of the General Counsel (OGC), and other appropriate agency officials when this issue arises.[17]

[17] Chapter 3, section 200, of the FTC *Administrative Manual* does provide agency managers guidance that "[q]uarterly reviews of experts and consultants (FTC Form 244) will be made to determine the propriety of duties performed, observance of time limits, and adequacy of documentation. These reviews will be conducted by [HCMO] after submission of FTC Form 244 by the Office Head or designee (Headquarters) or Regional Director (Regional Offices). The FTC Form 244 will be retained by [HCMO] and made available for post-audit." Another management control listed by the *Administrative Manual* guides managers to review annually "the regulations governing experts and consultants." However, neither the relevant guidance nor the FTC Form 244 includes

As a result, the FTC cannot reasonably ensure that unpaid consultants and experts will be restricted from performing inherently governmental functions. Without clear boundaries on the roles and responsibilities of FTC managers, unambiguous guidance on prohibited activities of unpaid consultants and experts, and an effective process of monitoring and review over their activities, the FTC runs a greater risk that non-federal employees will either undertake or be assigned to prohibited duties.

Recommendation

1. We recommend that the Executive Director, in coordination with bureau directors, develop internal policy or guidance requiring documenting unpaid consultants' and experts' scope of work—including guidance on allowable and prohibited activities and a process for communicating the scope of work with candidates prior to their time with the FTC.

B. The FTC Has Not Sufficiently Developed Criteria for Its Unpaid Consultants and Experts

Upon arrival at the agency, and throughout their tenure there, the FTC considers its unpaid consultants and experts who advise senior Commission leaders as making significant contributions to the mission and becoming integral to the agency's strategic direction. The individuals occupying these positions are not permanent (full- or part-time) civil servant federal employees. As such, the FTC maintains these individuals' justifications and approvals—routed more recently through OGC—that include term end dates and general activities that these individuals will participate in during their temporary stay with the agency.

These justifications, however, do not contain sufficient caveats and restrictions that would limit the agency's exposure to a variety of risks. Without properly constructed agreements beyond justifications—clearly stating unpaid consultants' and experts' expressly allowable activities and restrictions in consideration of the unique roles they fill—both the agency and the individuals lack sufficient protection throughout and after their tenure with the FTC.

Effective enterprise risk management (ERM)—including the exploration, analysis, and documentation of third-party provider risks—is essential to the effective and sound operation of the agency. The FTC agency has not determined whether the risks of using unpaid consultants and experts aligns with what its ERM has deemed a tolerable level.

Understanding the potential impact and likelihood of risks helps agencies with the formulation of internal control. The GAO's *Standards for Internal Control in the Federal Government* (the GAO Green Book) instructs agency management to define objectives clearly (i.e., in specific and measurable terms) to enable the identification of risks and define risk tolerances. Specific terms, fully and clearly set forth, are easily understood by managers and their staff. Measurable terms allow management to assess staff

language specifying what process managers must follow when an unpaid consultant's/expert's activities approach the proximity of a function reserved for federal employees only, as identified by OMB OFPP Policy Letter 11-01.

performance toward achieving objectives. After management initially sets objectives, they refine them as they incorporate them into the internal control system.

Absent clear, specific objectives for each unpaid consultant or expert, the FTC remains vulnerable because it does not establish sufficiently comprehensive agreements by the time unpaid consultants and experts arrive on board. The agency must manage the risks more deliberately, and proactively; otherwise, it will be challenged to identify, intervene in, and stop the involvement of unpaid consultants and experts in prohibited activities.

An OIG review of the language contained in some of the nine justifications we considered in this audit included "act as a key source of technical and policy expertise to facilitate visionary strategic initiatives." Such vague language allows for overly broad interpretations of what role each unpaid consultant or expert will be filling, beyond their office assignment. In addition, none of the nine justifications we reviewed contained language identifying activities that the unpaid consultant or expert would be *restricted* from performing. In summary, as it increasingly turns to unpaid consultants and experts, the FTC has not fully considered these or other specific risks that could provide better clarity on roles, responsibilities, and restrictions. Without the development of restrictive agreements on allowable activities—and greater communication with pertinent agency officials—the agency lacks an important layer of assurance against potential ethical dilemmas, such as conflicts of interest.

The FTC does not purposefully identify its unpaid consultants or experts as third-party providers, similar to those relationships it has with contractors. As such, despite the increasing use of these individuals, the FTC has not defined broader objectives or goals on their deployment or communicated an organizational strategy, either within the third-party agreements or elsewhere in policy.

As a result, when entering into relationships with unpaid consultants and experts (i.e., in third-party provider relationships) without formal agreements, the FTC has unnecessary exposure to operational, legal, compliance, and reputational risk. Operational risk emerges when unpaid consultants or experts conduct FTC business without regard to their purpose, due to a lack of formal working boundaries. Legal risk arises from decisions made by such employees that could potentially be invalidated due to their position. Compliance risk follows when such third parties are placed in situations requiring them to perform inherently governmental functions (see previous subfinding I.A). Finally, reputational risk accompanies each of these other risks when full-time employees working with these third parties lack clarity on roles and targeted outcomes.

Recommendation

2. We recommend that the Executive Director, in coordination with office and bureau directors, establish individual employment agreements for each unpaid consultant and expert, delineating roles and restrictions for each position.

II. The FTC Identifies, Recruits, and Selects Unpaid Consultants and Experts Without Uniformity and Transparency Across All Agency Stakeholders

The processes by which the FTC onboards and deploys its unpaid experts and consultants pose a number of risks. Currently, the identification, recruitment, and selection of unpaid consultants and experts is conducted on an ad hoc basis—which the OIG observed has contributed to confusion about where these consultants are located organizationally, the goals and scope of their work, and their objectives.

A program such as the agency's unpaid consultants and experts requires consistency and clarity. The activities and responsibilities involved in determining the needs, the criteria for evaluation, and the final selection of these unpaid services should be informed by and documented using agency-wide policy. According to the GAO Green Book, "management should implement control activities through policies." Further, management should document, in policy, the responsibilities of program units to meet objectives, the design of control activities, the implementation of controls, and the response to risks. Additionally, the Green Book states that management should use quality information to make informed decisions about the use and prioritization of resources, as well as evaluating agency performance and potential risk areas that could affect efficiency and effectiveness.

At the FTC, we found no agency-wide policy in place for onboarding and managing unpaid consultants and experts. For example, there is no documented process (formal or informal) for identifying and recruiting candidates. Further, the FTC does not have a consistent policy or clear set of procedures guiding the identification of needed expertise, the search and selection process of individual unpaid consultants and experts, and the scope of work that they will participate in while at the agency.

In our discussions with agency personnel involved in the onboarding of unpaid consultants and experts, we found that many key internal stakeholders—such as the Human Capital Management Office (HCMO) and FTC managers of the unpaid positions—are also uninformed about and have little to no input on the recruitment and selection process. This has occurred even as the FTC has increasingly relied on unpaid consultants and experts. FTC leadership has not (a) clearly communicated program goals to, (b) allotted sufficient resources for program control development to, or (c) incorporated input from stakeholders across the agency.

As a result, the agency cannot determine whether its decisions on recruiting and selecting unpaid consultants or experts are informed with the best available information. Without a tighter structure guiding the hiring of unpaid consultants and experts, there persists a level of operational risk—which leaves the agency vulnerable to confusion about where organizationally these unpaid positions lie, as well as their purpose. This operational risk can lead to inefficient use of the valuable resources that unpaid experts and consultants provide.

Recommendation

3. We recommend that the Executive Director, in coordination with bureau directors, develop and disseminate unpaid consultant and expert program policies and procedures for identifying and documenting position needs and standardizing recruitment and selection.

SUMMARY OF AGENCY RESPONSE AND OIG COMMENTS

In a written response to this report, FTC management concurred with all three recommendations and described planned actions that were responsive. The FTC response to our report is included in its entirety in appendix C.

APPENDIX A: OBJECTIVE, SCOPE, AND METHODOLOGY

We conducted a performance audit to determine whether the FTC's program to hire and oversee unpaid consultants and experts is managed in accordance with federal and agency requirements. As background for our audit, we researched and reviewed pertinent authorities, including federal laws and regulations, agency guidance, policies, and procedures. These included 5 U.S.C. § 3109, *Employment of experts and consultants, temporary or intermittent*; 5 C.F.R. § 304, *Expert and Consultant Appointments*; OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Controls*; OMB Circular A-76, *Performance of Commercial Activities*; the GAO *Standards for Internal Control in the Federal Government*; internal FTC policies; and policy memoranda. We also reviewed prior audit reports issued by other OIGs and GAO relevant to unpaid positions. During fieldwork, we conducted interviews with FTC officials and performed analysis on records. In planning and performing our audit, we identified the internal control components germane to our audit objective. We gained an understanding of controls over the unpaid positions and performed testing on documentation.

As part of our audit methodology, we reviewed and performed analysis on the following documentation:

- FTC Form FTC-189, *Justification and Approval of Employment of Expert/Consultant* for all experts and consultants included in our scope
- Memoranda of understanding (MOUs)/agreements between the FTC and other federal agencies documenting the understanding between parties completed for all details
- Interim suitability determinations prior for all unpaid positions
- HCMO welcome letters provided to unpaid experts and consultants

We conducted testing of the following, to confirm whether

- all unpaid consultants and experts and IPAs had signed waivers in advance of service to the FTC, waiving any claim for compensation for their services in accordance with 5 C.F.R. §§ 304.104, 334.106;
- all unpaid experts and consultants—as well as details, PIFs, PMFs, and IPAs—completed the required FTC security awareness training prior to onboarding at the agency, in compliance with the FTC *Administrative Manual*, chapter 3, section 830—Personnel Security; and
- an FTC Form 244 was completed for each expert and consultant who came on board prior to December 31, 2021, in compliance with the FTC *Administrative Manual*, chapter 3, section 200—Employment of Experts and Consultants (there was no significant changes in duty from the original justifications; however, there were some adjustments to the language as discussed in Findings and Recommendations).

As part of our audit, we identified the total population of the unpaid positions for the period covering October 2020–March 2022. The scope of the audit originally included 5 different types of paid and unpaid positions (refer to table 2 below for additional detail) and subsequently used a risk-based approach to refine our audit scope. We conducted research on the types of paid and unpaid positions at the FTC and reviewed the policies and procedures supporting the programs. Based on our research, we narrowed the focus of our audit should be on the unpaid consultants and experts.

Table 1: Unpaid Positions at the FTC

Type of Unpaid Position	Number of Participants
Detail	4
PIF	2
PMF	1
IPA	1
Consultant/expert	9
Total Participants	**17**

To ensure data reliability of records received from the FTC, we first requested the following from HCMO:

- program-level documentation;
- documents related to the unpaid positions program, including justifications/approvals, MOUs/agreements, interim suitability determinations, welcome letters to unpaid experts/consultants, documentation that unpaid experts/consultants had completed the IT Rules of Behavior for access to the FTC systems, and signed waivers for uncompensated positions; and
- a list of unpaid FTC staff from January 2018 to March 2022.

Then we compared data received from HCMO on the number of consultants and unpaid volunteers to the spreadsheet we developed from the new employee orientations, to determine whether data were sufficiently reliable for selecting samples to test.

We used the following criteria in the performance of our audit:

- FTC, *Administrative Manual*, chapter 3, section 200—Employment of Experts and Consultants (updated March 2006)
- GAO *Standards for Internal Control in the Federal Government*
- OMB Circular A-76, *Performance of Commercial Activities*

- OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*
- 5 U.S.C. § 3109, *Employment of experts and consultants; temporary or intermittent*
- 5 C.F.R. Ch. 304, *Expert and Consultant Appointments*

We performed the audit work remotely from February 28, 2022, through June 28, 2022. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

APPENDIX B: ACRONYMS AND ABBREVIATIONS

BCP	FTC Bureau of Consumer Protection
BE	FTC Bureau of Economics
CFR	Code of Federal Regulations
FTC	Federal Trade Commission
GAO	U.S. Government Accountability Office
HCMO	FTC Human Capital Management Office
IPA	Intergovernmental Personnel Act of 1970
MOU	Memorandum of understanding
OFPP	U.S. Office of Personnel Management Office of Federal Procurement Policy
OGC	FTC Office of the General Counsel
OMB	Office of Management and Budget
OPM	U.S. Office of Personnel Management
OPP	FTC Office of Policy Planning
PIF	Presidential Innovation Fellow
PMF	Presidential Management Fellow
USC	U.S. Code

APPENDIX C: FTC MANAGEMENT RESPONSE

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Human Capital Management Office

Date: July 22, 2022

To: Andrew Katsaros, Inspector General

Thru: David Robbins, Executive Director DAVID ROBBINS Digitally signed by DAVID ROBBINS Date: 2022.07.21 12:41:06 -04'00'

From: Sharrelle Higgins, Deputy Chief Human Capital Officer SHARRELLE HIGGINS Digitally signed by SHARRELLE HIGGINS Date: 2022.07.21 11:10:46 -04'00'

Subject: Management's Response to Draft Report on Audit of the Federal Trade Commission's Unpaid Consultant and Expert Program

Thank you for the opportunity to provide comments on the draft report.

The FTC concurs with the recommendations and propose the following actions. The estimated completion dates will be established within 60 days of issuing the Final OIG Audit Report regarding this matter.

OIG Recommendation 1: We recommend that the Executive Director, in coordination with bureau directors, develop internal policy or guidance requiring documenting unpaid consultants' and experts' scope of work—including guidance on allowable and prohibited activities and a process for communicating the scope of work with candidates prior to their time with the FTC.

Planned Action: The Executive Director, together with staff in the Human Capital Management Office (HCMO) and the Office of General Counsel, and in coordination with the FTC's Bureau and Office Directors, will review, update, and finalize Administrative Manual Chapter 3 Section 200 – Employment of Experts and Consultants, which will include documenting unpaid consultants' and experts' scope of work, provide guidance on allowable vs prohibited activities and communicate the scope of work with candidates prior to them beginning work at the FTC.

OIG Recommendation 2: We recommend that the Executive Director, in coordination with office and bureau directors, establish individual employment agreements for each unpaid consultant and expert, delineating roles and restrictions for each position.

Planned Action: The Executive Director, together with staff in the Human Capital Management Office (HCMO) and the Office of General Counsel, and in coordination with the FTC's Bureau and Office Directors, will establish individual employment agreements for each unpaid consultant and expert, delineating roles and restrictions for each position.

OIG Recommendation 3: We recommend that the Executive Director, in coordination with bureau directors, develop and disseminate unpaid consultant and expert program policies and procedures for identifying and documenting position needs and standardizing recruitment and selection.

Planned Action: The Executive Director, together with staff in the Human Capital Management Office (HCMO) and the Office of General Counsel, and in coordination with the FTC's Bureau and Office Directors, in addition to the planned actions for Recommendation 1, which includes developing policies, will develop standard operating procedures and guidance for onboarding and managing unpaid consultants and experts and standardizing recruitment and selection.

Center for AI and Digital Policy

April 18, 2023

Committee Chairs and Ranking Members
House Energy and Commerce Committee
Innovation, Data, and Commerce Subcommittee
2125 Rayburn House office Building
Washington, DC

Dear Committee Chair Rodgers, Ranking Member Pallone, Subcommittee Chair Bilirakis, and Ranking Member Schakowsky

We write to you regarding the upcoming FY24 budget hearing for the Federal Tarde Commission.[1] *We request that you ask the FTC Commissioners about their efforts to address public concern about the commercial deployment of AI products, and specifically whether the Commission has Opened the Investigation of OpenAI and GPT-4, as we have urged*

We filed the FTC Complaint about OpenAI and GPT-4 on March 30, 2023. We alleged that the company had violated the FTC's specific guidance for the offering of AI products. Just before we sent the complaint, we published a letter in *The New York Times* in which we wrote:

> The recent coverage of Washington's response to artificial intelligence is a welcome shift toward an overdue policy debate. But the challenge ahead is not so much about educating lawmakers about new technology as it is about establishing the necessary safeguards to protect the public.[2]

Our concern about the absence of necessary guardrails for AI products was also set out in Ms. Hickok's testimony before the House Oversight Committee.[3]

> we do not have the guardrails in place, the laws that we need, the public education, or the expertise in government to manage the consequences of the rapid changes that are now taking place. Internationally, we are losing AI-policy leadership. Domestically, Americans say they're more concerned than excited about AI.[4]

---

[1] *Year 2024 Federal Trade Commission Budget,* House Energy and Commerce Committee, Subcommittee on Innovation, Data and Commerce, April 18, 2023, https://energycommerce.house.gov/events/innovation-data-and-commerce-subcommittee-hearing-fiscal-year-2024-federal-trade-commission-budget

[2] Marc Rotenberg and Merve Hickok, *Regulating A.I.: The U.S. Needs to Act*, The New York Times, March 6, 2023, https://www.nytimes.com/2023/03/06/opinion/letters/alex-murdaugh.html

[3] House Committee on Oversight and Accountability, Subcommittee on Cybersecurity, Information Technology, and Government Innovation, *Advances in AI: Are We Ready For a Tech Revolution?* March 8, 2023, https://oversight.house.gov/hearing/advances-in-ai-are-we-ready-for-a-tech-revolution/

[4] Testimony and Statement for the Record of Merve Hickok Chairwoman and Research Director, Center for AI and Digital Policy, *Advances in AI: Are We Ready For a Tech Revolution*? House Committee on Oversight and

At the time we filed the FTC complaint, we sent a copy of the cover letter to Chairman Rodgers and Ranking Member Pallone.[5] We explained that OpenAI had identified almost a dozen risks that could result from the release of GPT-4, including "Disinformation and influence operations," the "Proliferation of conventional and unconventional weapons," and "Cybersecurity attacks." Yet, the company went ahead with the release of the product.

We also called attention to the fact that the FTC has previously declared that the use of AI should be "transparent, explainable, fair, and empirically sound while fostering accountability." GPT-4 satisfied none of these requirements. We wrote, "Alarm bells should be ringing."

In the two weeks that have passed since we filed the 46-page complaint, there has been no acknowledgment by the FTC of the Complaint and no indication that the FTC has taken any action. Meanwhile, consumer privacy agencies around the world, national governments, and many, many AI experts are moving quickly to establish new safeguards to protect the public.

Of particular interest is the investigation undertaken by the Italian Supervisory Authority of chatGPT. On March 31, 2023 the Italian Supervisory Authority announced a temporary ban of the product pending the establishment of safeguards. Within two weeks of that announcement, the agency set out the conditions for compliance and anticipated that the matter could be resolved by mid-May. It is a remarkable display of agency efficiency.

We are aware that there are efforts underway in the United States to address growing concerns about the risks that certain AI techniques may pose to society. The White House Office of Science and Technology Policy has set out a Blueprint for an AI Bill of Rights.[6] The National Telecommunications and Information Administration (NTIA) has opened a request for public comment on AI accountability.[7]

But the issue of consumer protection remains central. The President recently explained the need to address the potential risks of AI to society, the economy, and national security. He called for "responsible innovation and appropriate guardrails to protect America's rights and safety, and protecting their privacy, and to address the bias and disinformation." [8] He

---

Accountability, Subcommittee on Cybersecurity, Information Technology, and Government Innovation, March 8, 2023, https://oversight.house.gov/wp-content/uploads/2023/03/Merve-Hickok_testimony_March-8th-2023.pdf

[5] Center for AI and Digital Policy (CAIDP), *Letter to Chair Kahn, Commissioner Slaughter, Commissioner Wilson, and Commissioner Bedoya,* March 30, 2023, https://www.caidp.org/app/download/8452628163/CAIDP-FTC-OpenAI-GPT4-04032023.pdf

[6] The White House, Office of Science and Technology Policy, *Blueprint for An Bill Rights: Making Automated Systems Work for the American People,* https://www.whitehouse.gov/ostp/ai-bill-of-rights/

[7] NTIA, *AI Accountability Policy Request for Comment*, April 11, 2023, https://ntia.gov/issues/artificial-intelligence/request-for-comments

[8] The White House, *Remarks by President Biden in Meeting with the President's Council of Advisors on Science and Technology,* April 4, 2023, https://www.whitehouse.gov/briefing-room/speeches-remarks/2023/04/04/remarks-by-president-biden-in-meeting-with-the-presidents-council-of-advisors-on-science-and-technology/

said specifically, "tech companies have a responsibility to make sure their products are safe before making them public." [9]

For the budget hearing, we urge you to press the FTC Commissioners on these issues:

- Have you received the complaint from the Center for AI and Digital Policy (CAIDP) regarding OpenAI and GPT?
- Do you have a preliminary assessment of the Complaint?
- Has the FTC opened an investigation concerning OpenAI?
- Do the various statements that the FTC has issued regarding AI products apply to GPT?
- How do you plan to enforce your guidelines with companies that offer generative AI products, such as OpenAI?
- What could be the consequences for consumers if the FTC fails to take action against companies offering AI products?

We appreciate your consideration of this matter. We believe our complaint is one of the most pressing matters currently before the Commission. Please contact us if we can be of any assistance to the Committee or the Subcommittee.

We ask that this Statement be included in the hearing record.

Sincerely yours,

Merve Hickok, President
Center for AI and Digital Policy

Marc Rotenberg, Executive Director
Center for AI and Digital Policy

Attachments

CAIDP, FTC Complaint, March 30, 2023
Marc Rotenberg and Merve Hickok, *Regulating A.I.: The U.S. Needs to Act*, The New York Times, March 6, 2023,

[9] Id.

FEDERAL TRADE COMMISSION
Washington, DC 20580

In the matter of	)
	)
OpenAI, Inc.	)
	)

Submitted by

The Center for Artificial Intelligence and Digital Policy (CAIDP)

I. Summary

1. OpenAI, Inc., a California-based corporation, has released a product GPT-4 for the consumer market that is biased, deceptive, and a risk to privacy and public safety. The outputs cannot be proven or replicated. No independent assessment was undertaken prior to deployment. OpenAI has acknowledged the specific dangers of "Disinformation and influence operations," "Proliferation of conventional and unconventional weapons," and "Cybersecurity." OpenAI has warned that "AI systems will have even greater potential to reinforce entire ideologies, worldviews, truths and untruths, and to cement them or lock them in, foreclosing future contestation, reflection, and improvement." The company already disclaims liability for the consequences that may follow.

2. The Federal Trade Commission has declared that the use of AI should be "transparent, explainable, fair, and empirically sound while fostering accountability." OpenAI's product GPT-4 satisfies none of these requirements. It is time for the FTC to act. There should be independent oversight and evaluation of commercial AI products offered in the United States. CAIDP urges the FTC to open an investigation into OpenAI, enjoin further commercial releases of GPT-4, and ensure the establishment of necessary guardrails to protect consumers, businesses, and the commercial marketplace.

II. Parties

3. The Center for AI and Digital Policy is a non-profit, research organization, incorporated in Washington, DC. CAIDP's global network of AI policy experts and advocates spans 60 countries.[1] CAIDP provides training to future AI policy leaders.[2] CAIDP undertook the first comprehensive review of national AI policies and practices.[3] CAIDP routinely provides policy advice on AI and emerging technologies to national governments and international organizations.[4]

4. OpenAI is an American artificial intelligence (AI) research laboratory consisting of the non-profit OpenAI Incorporated (OpenAI Inc.) and its for-profit subsidiary corporation OpenAI Limited Partnership (OpenAI LP).[5] OpenAI was founded in 2015.

III. Jurisdiction

5. The Federal Trade Commission may "prosecute any inquiry necessary to its duties in any part of the United States," FTC Act Sec. 3, 15 U.S.C. Sec. 43, and is authorized "to gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any person, partnership, or corporation engaged in or whose business affects commerce, excepting banks, savings and loan institutions . . . Federal credit unions . . . and common carriers . . . ." FTC Act Sec. 6(a), 15 U.S.C. Sec. 46(a).[6]

---

[1] CAIDP, caidp.org
[2] CAIDP, AI Policy Clinics, https://www.caidp.org/global-academic-network/ai-policy-clinic/
[3] CAIDP, *AI and Democratic Values* (2020)
[4] CAIDP, *Statements*, https://www.caidp.org/statements/. *See, e.g.,* CAIDP Statement to the US National AI Advisory Committee regarding US National As Strategy, Mar. 3, 2023, https://www.caidp.org/app/download/8445403363/CAIDP-Statement-NAIAC-03032023.pdf
[5] Open AI, *OpenAI LP*, https://openai.com/blog/openai-lp
[6] FTC*, A Brief Overview of the Federal Trade Commission's Investigative, Law Enforcement, and Rulemaking Authority (May 2021), https://www.ftc.gov/about-ftc/mission/enforcement-authority*

6. The FTC has authority to investigate, prosecute, and prohibit "unfair or deceptive acts or practices in or affecting commerce."[7]

7. OpenAI has released the AI-based products, DALL-E, GPT-4, OpenAI Five, ChatGPT, and OpenAI Codex for commercial use. OpenAI has described these AI models as "products."

8. OpenAI currently provides "pricing information" for these products.[8] Pricing information is available for the Language Models GPT-4, Chat, and InstructGPT.[9] For the GPT-4 32k Context Model, 1k of Prompt tokens may be purchased for $0.06 and 1k of Completion tokens may be purchased for $0.12. Open AI also provides pricing information for Fine-tuning models and Embedded models. OpenAI provides pricing information for Other models, including Image Models and Audio Models."

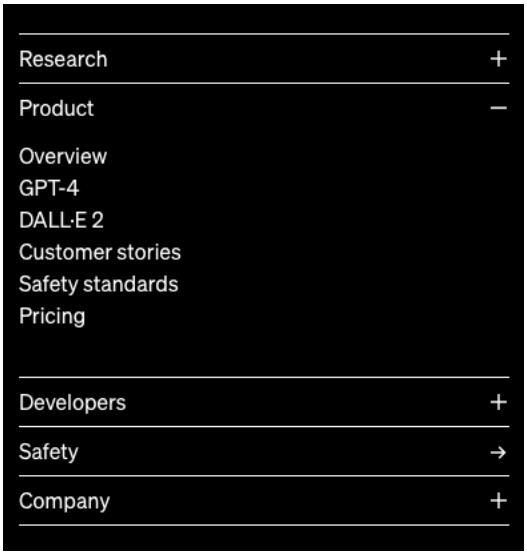


Image 1: Screenshot from OpenAI website showing "Products" (March 25, 2023)

[7] 15 U.S.C. §45 (a)(1), (2), (4)(A), 4(B); (m)(1)(A); m(1)(B) ("Declaration of unlawfulness; power to prohibit unfair practices); (b) (proceedings by the Commission")
[8] OpenAI, Pricing, https://openai.com/pricing
[9] Id.

9. OpenAI has made available plugins for GPT-4 for routine consumer services, including travel, finance, and shopping.[10] "Initially, there will only be 11 plugins available. These plugins range from allowing users to check the scores of live sporting events to booking an international flight and purchasing food for home delivery."[11]

IV. Public Policy for the Governance of AI

10. There are emerging norms for the governance of AI, derived from the formal commitments of the United States government and recommendations endorsed by legal experts, technical experts, and scientific societies.

A. The OECD AI Principles

11. The Organization for Economic Cooperation and Development ("OECD") was established in 1961 to promote economic cooperation and development.[12]

12. There are presently 38 members of the OECD, including the United States.[13]

13. In 2019, the member nations of the OECD, working also with many non-OECD members countries, promulgated the OECD Principles on Artificial Intelligence.[14]

14. The United States has endorsed the OECD AI Principles.[15]

15. The G-20 Countries have endorsed the OECD AI Principles.[16]

---

[10] OpenAI, **ChatGPT plugins**

[11] Brayden Lindrea, Cointelegraph, *ChatGPT can now access the internet with new OpenAI plugins*, Mar. 24, 2023, https://cointelegraph.com/news/chatgpt-can-now-access-the-internet-with-new-openai-plugins

[12] *History*, OECD, oecd.org/about/history.

[13] Id.

[14] *Recommendation of the Council on Artificial Intelligence*, OECD (May 21, 2019), legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0449.

[15] *U.S. Joins with OECD in Adopting Global AI Principles*, NTIA (May 22, 2019), https://www.ntia.doc.gov/blog/2019/us-joins-oecd-adopting-global-ai-principles.

[16] *G20 Ministerial Statement on Trade and Digital Economy*, https://www.mofa.go.jp/files/000486596.pdf

16. According to the OECD AI Principle on Human-Centered Values and Fairness, "AI actors should respect the rule of law, human rights and democratic values, throughout the AI system lifecycle. These include freedom, dignity, and autonomy, privacy and data protection, non- discrimination and equality, diversity, fairness, social justice, and internationally recognized labour rights."[17]

17. According to the OECD AI Principle on Robustness, Security, and Safety, "AI systems should be robust, secure and safe throughout their entire lifecycle so that, in conditions of normal use, foreseeable use or misuse, or other adverse conditions, they function appropriately and do not pose unreasonable safety risk."[18]

18. According to the OECD AI Principle on Transparency and Explainability, AI Actors should "provide meaningful information, appropriate to the context, and consistent with the state of art (i) to foster a general understanding of AI systems, (ii) to make stakeholders aware of their interactions with AI systems, including in the workplace, (iii) to enable those affected by an AI system to understand the outcome, and (iv) to enable those adversely affected by an AI system to challenge its outcome based on plain and easy-to-understand information on the factors, and the logic that served as the basis for the prediction, recommendation or decision."[19]

19. According to the OECD AI Principle on Accountability, "[o]rganisations and individuals developing, deploying or operating AI systems should be held accountable for their proper functioning in line with the above principles."[20]

---

[17] OECD Principle 1.2(a).

[18] OECD Principle 1.4(a)
[19] OECD Principle 1.3
[20] OECD Principle 1.5.

20. The OECD Principles on Artificial Intelligence are "established public policies" within the meaning of the FTC Act.[21]

B. The Universal Guidelines for AI

21. The Universal Guidelines for Artificial Intelligence ("UGAI"), a framework for AI governance based on the protection of human rights, were set out at the 2018 meeting of the International Conference on Data Protection and Privacy Commissioners in Brussels, Belgium, hosted by the former European Data Protection Supervisor, Giovanni Buttarelli.[22]

22. The UGAI have been endorsed by more than 300 experts and 70 organizations in 40 countries.[23]

23. According to the UGAI Right to Transparency, "All individuals have the right to know the basis of an AI decision that concerns them. This includes access to the factors, the logic, and techniques that produced the outcome."[24]

24. According to the UGAI Fairness Obligation, "Institutions must ensure that AI systems do not reflect unfair bias or make impermissible discriminatory decisions."[25]

25. According to the UGAI Assessment and Accountability Obligation, "An AI system should be deployed only after an adequate evaluation of its purpose and objectives, its benefits, as well as its risks."[26]

---

[21] 15 U.S.C. § 45(n).
[22] *Universal Guidelines for Artificial Intelligence*, The Public Voice (Oct. 23, 2018), https://thepublicvoice.org/ai-universal-guidelines/; thepublicvoice.org/events/brussels18.
[23] *Universal Guidelines for Artificial Intelligence: Endorsement*, The Public Voice (Oct. 23, 2019), https://thepublicvoice.org/AI-universal-guidelines/endorsement/.
[24] UGAI Guideline 1.
[25] UGAI Guideline 4.
[26] UGAI Guideline 5.

26. According to the UGAI Accuracy, Reliability, and Validity Obligations, "Institutions must ensure the accuracy, reliability, and validity of decisions."[27]

27. According to the UGAI Termination Obligation, "An institution that has established an AI system has an affirmative obligation to terminate the system if human control of the system is no longer possible."[28]

28. The Universal Guidelines for Artificial Intelligence are "established public policies" within the meaning of the FTC Act.[29]

V. Factual Background

A. OpenAI

29. In 2016, Open AI stated that its mission is "to ensure that artificial general intelligence (AGI)—by which we mean highly autonomous systems that outperform humans at most economically valuable work—benefits all of humanity. We will attempt to directly build safe and beneficial AGI, but will also consider our mission fulfilled if our work aids others to achieve this outcome."[30] OpenAI set out several Principles to which it committed: Broadly distributed benefits, Long-term safety, Technical leadership, and Cooperative orientation.

30. Since 2016, the business structure, business practices, and business activities of OpenAI have changed. In 2019, OpenAI transitioned into a for-profit company. OpenAI CEO Altman received $1 billion in funding from Microsoft, which agreed to license and commercialize some of OpenAI's technology.[31]

---

[27] UGAI Guideline 6.
[28] UGAI Guideline 10.
[29] 15 U.S.C. § 45(n).
[30] OpenAI Charter, https://openai.com/charter.
[31] Pranshu Verma, *What to know about OpenAI, the company behind ChatGPT*, Washington Post, Mar. 14, 2023, https://www.washingtonpost.com/technology/2023/02/06/what-is-openai-chatgpt/; see also, Chloe Xiang, *OpenAI Is Now Everything It Promised Not to Be: Corporate, Closed-Source, and For-Profit*, Vice, Feb. 28, 2023,

31. Sam Altman, the co-founder of OpenAI, is also the founder of WorldCoin, a company that seeks to obtain the iris scans of virtually every person in the world.[32]

B. GPT

32. In this complaint, "GPT" refers to Generative Pre-trained Transformer, a family of artificial intelligence large language models.

33. According to Wikipedia, the original paper on generative pre-training (GPT) of a language model was published in preprint on OpenAI's website in 2018.[33] The paper demonstrated how "a generative model of language is able to acquire world knowledge and process long-range dependencies by pre-training on a diverse corpus with long stretches of contiguous text."[34]

34. GPT-2 was first announced in February 2019, with only limited demonstrative versions initially released to the public. The full version of GPT-2 was not immediately released out of concern over potential misuse, including applications for writing fake news.[35]

35. On March 15, 2023, OpenAI published the GPT-4 Technical Report.[36] The 99-page report provides an overview of the capabilities, limitations, risks and mitigation of GPT-4. The Technical Report includes an Abstract as well as a discussion of the Scope and Limitations

---

https://www.vice.com/en/article/5d3naz/openai-is-now-everything-it-promised-not-to-be-corporate-closed-source-and-for-profit

[32] Connie Loizos, *Worldcoin, co-founded by Sam Altman, is betting the next big thing in AI is proving you are human*, Mar. 8, 2023, https://techcrunch.com/2023/03/07/worldcoin-cofounded-by-sam-altman-is-betting-the-next-big-thing-in-ai-is-proving-you-are-human/; Ellen Huet, Crypto Startup That Wants to Scan Everyone's Eyeballs Is Having Some Trouble, Bloomberg, Mar. 16, 2022. ("Worldcoin aims to photograph the irises of every person on earth . . ."), https://www.bloomberg.com/news/articles/2022-03-16/worldcoin-the-eyeball-scanning-crypto-unicorn-hits-signup-snags?

[33] Alec Radford, Karthik Narasimhan, Tim Salimans, Ilya Sutskever, *Improving Language Understanding by Generative Pre-Training*, OpenAI, https://cdn.openai.com/research-covers/language-unsupervised/language_understanding_paper.pdf.

[34] Wikipedia, *OpenAI,* https://en.wikipedia.org/wiki/OpenAI

[35] Alex Hern, *New AI fake text generator may be too dangerous to release, say creators: The Elon Musk-backed nonprofit company OpenAI declines to release research publicly for fear of misuse,* The Guardian, Feb. 14, 2019, https://www.theguardian.com/technology/2019/feb/14/elon-musk-backed-ai-writes-convincing-news-fiction

[36] OpenAI, *GPT-4 Technical Report (2023)*, https://cdn.openai.com/papers/gpt-4.pdf

of the Technical Report. The Technical Report includes an appendix that discusses, Exam Benchmark Methodology, the Impact of RHLF on capability, and other topics. Open AI concluded the Technical Report with this statement, "GPT-4 presents new risks due to increased capability, and we discuss some of the methods and results taken to understand and improve its safety and alignment. Though there remains much work to be done, GPT-4 represents a significant step towards broadly useful and safely deployed AI systems."[37]

36. This Complaint quotes extensively from the GPT-4 Technical Report.

37. On March 15, 2023, OpenAI also published the GPT-4 System Card. The System Card analyzes GPT-4, the latest Large Language Model, and the focus of this Complaint. The System Card identifies safety challenges, identified to date, by OpenAI and the Model capabilities. The System Card describes, at "a high level," the safety processes adopted by OpenAI prior to deployment of GPT-4. OpenAI states that their "mitigations and processes alter GPT-4's behavior and prevent certain kinds of misuses." Nonetheless, these efforts are "limited and remain brittle . . ." OpenAI concedes that "this points to the need for anticipatory planning and ***governance***."[38]

38. This Complaint also quotes extensively from the GPT-4 System Card.

VI. Open AI's Business Practices are Unfair and Deceptive, Violate FTC Statements, Reports, and Guidelines for AI Practices and Emerging Legal Norms for the Governance of Artificial Intelligence

C. Bias

[37] Technical Report at 14.
[38] Open AI, *The GPT-4 System Card*, Mar.15 2023. https://cdn.openai.com/papers/gpt-4-system-card.pdf (emphasis added).

39. Central to consumer protection is the fair and equal treatment of all consumers. Consumer protection law prohibits bias across large sectors of the US economy, including credit, education, employment, housing and travel.[39]

40. President Biden has made clear the need to ensure equity, specifically in the deployment of AI systems across the federal government.[40] The President's *Executive Order on Further Advancing Racial Equity and Support for Underserved Communities Through The Federal Government* states , "Agencies shall comprehensively use their respective civil rights authorities and offices to prevent and address discrimination and advance equity for all. Agencies shall . . . prevent and remedy discrimination, including by protecting the public from algorithmic discrimination."

41. The US Office of Science and Technology Policy (OSTP) has stated that "Algorithms used in hiring and credit decisions have been found to reflect and reproduce existing unwanted inequities or embed new harmful bias and discrimination."[41]

42. The National Institute of Standards and Technology has released Special Publication 1270, *Towards a Standard for Identifying and Managing Bias in Artificial Intelligence*.[42] The publication describes the challenges of bias in AI and provides examples of how bias in AI diminishes public trust in AI systems.

---

[39] Federal Trade Commission Act of 1914, 15 U.S.C. § 45, as amended; Fair Credit Reporting Act of 1970 (FCRA), 15 U.S.C. § 1681 *et seq*.; Equal Credit Opportunity Act of 1974 (ECOA), 15 U.S.C. § 1691 *et seq*.; The Fair Housing Act of 1988, 42 U.S.C. § 3601 *et seq*.; Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e *et seq*., as amended; Title VI of the Civil Rights Act of 1964, 42 U.S.C. § 2000d *et seq*., as amended; Title IX of the Education Amendments of 1972, 20 U.S.C. §1681 *et. seq*.; The Air Carrier Access Act of 1986 (ACAA), 49 U.S.C. §§ 40127(a), 41310(a), 41712, and 41702.

[40] President Joseph R. Biden, Jr., *Executive Order on Further Advancing Racial Equity and Support for Underserved Communities Through The Federal Government*, Sec. 8(f), Mar. 16, 2023, https://www.whitehouse.gov/briefing-room/presidential-actions/2023/02/16/executive-order-on-further-advancing-racial-equity-and-support-for-underserved-communities-through-the-federal-government/

[41] The White House, *Blueprint for An AI Bill of Rights*, https://www.whitehouse.gov/ostp/ai-bill-of-rights/,

[42] Reva Schwartz, Apostol Vassilev, Kristen Greene, Lori Perine, and Andrew Bert, *NIST Special Publication 1270: Towards a Standard for Identifying and Managing Bias in Artificial Intelligence.* The National Institute of Standards and Technology, March, 2022. https://nvlpubs.nist.gov/nistpubs/ SpecialPublications/NIST.SP.1270.pdf

43. But as the authors of the *Stochastic Parrots* paper explain:

> LMs [Language Models] trained on large, uncurated, static datasets from the Web encode hegemonic views that are harmful to marginalized populations. We thus emphasize the need to invest significant resources into curating and documenting LM training data. . . When we rely on ever larger datasets we risk incurring documentation debt, i.e. putting ourselves in a situation where the datasets are both undocumented and too large to document post hoc. While documentation allows for potential accountability, undocumented training data perpetuates harm without recourse. Without documentation, one cannot try to understand training data characteristics in order to mitigate some of these attested issues or even unknown ones.[43]

44. OpenAI has specifically acknowledged the risk of bias, and more precisely, "***harmful stereotypical and demeaning associations for certain marginalized groups***." (emphasis added). In the GPT-4 System Card, Open AI states, "The evaluation process we ran helped to generate additional qualitative evidence of societal biases in various versions of the GPT-4 model. We found that the model has the potential to reinforce and reproduce specific biases and worldviews, including harmful stereotypical and demeaning associations for certain marginalized groups."[44]

45. On the OpenAI blog, the company states, "While we've made efforts to make the model refuse inappropriate requests, it will sometimes respond to harmful instructions or exhibit biased behavior. We're using the Moderation API to warn or block certain types of unsafe content, but we expect it to have some false negatives and positives for now."

46. OpenAI released GPT-4 to the public for commercial use with full knowledge of these risks.

---

[43] Emily M. Bender, Timnit Gebru, Angelina McMillan-Major, Margaret Mitchell, On *the Dangers of Stochastic Parrots: Can Language Models Be Too Big, FAccT '21: Proceedings of the 2021 ACM Conference on Fairness, Accountability, and Transparency* (*March 202). Pages 610, 615 (Stochastic Parrots"),* https://doi.org/10.1145/3442188.3445922

[44] System Card at 7.

D. Children's Safety

47. Children's safety in the digital environment is a foundational concern for pediatricians. According to HealthyChildren, "Overuse of digital media may place your children at risk of: Not enough sleep, Obesity, Delays in learning and social skills, Negative effect on school performance, Behavior problems, Problematic Internet use, Risky behavior, Sexting, loss of privacy & predators; and Cyberbullying."[45]

48. Senator Michael Bennett (D-CO) recently sent a letter to the CEO of OpenAI and other industry leaders to "highlight the potential harm to younger users of rushing to integrate generative artificial intelligence (AI) in their products and services."[46]

49. Senator Bennett wrote, " the race to deploy generative AI cannot come at the expense of our children. Responsible deployment requires clear policies and frameworks to promote safety, anticipate risk, and mitigate harm."[47]

50. Senator Bennet described how:

> researchers prompted My AI to instruct a child how to cover up a bruise ahead of a visit from Child Protective Services. When they posed as a 13-year-old girl, My AI provided suggestions for how to lie to her parents about an upcoming trip with a 31-year-old man. It later provided the fictitious teen account with suggestions for how to make losing her virginity a special experience by 'setting the mood with candles or music.'[48]

51. Senator Bennett also noted that the public introduction of AI-powered chatbots arrives during an epidemic of teen mental health. A recent report from the Centers for Disease Control and Prevention (CDC) found that 57 percent of teenage girls felt persistently sad or hopeless in 2021, and that one in three seriously contemplated suicide.[49]

---

[45] Healthychildren, *Constantly Connected: How Media Use Can Affect Your Child*, July 20, 2022 (Adapted from Beyond Screen Time: A Parent's Guide to Media Use (Copyright © 2020 American Academy of Pediatrics), https://www.healthychildren.org/English/family-life/Media/Pages/Adverse-Effects-of-Television-Commercials.aspx

[46] Senator Michael Bennett, *Bennett Calls on Tech Companies to Protect Kids as They Deploy AI Chatbots: Following Early Reports of Potentially Harmful Content from AI Chatbots, Bennet Urges Tech CEOs to Prioritize Young Americans' Safety,* Mar. 21, 2023, https://www.bennet.senate.gov/public/index.cfm/2023/3/bennet-calls-on-tech-companies-to-protect-kids-as-they-deploy-ai-chatbots

[47] Id.

[48] Id.

[49] Id.

52. The GPT-4 System Card provides no detail of safety checks conducted by OpenAI during its testing period, nor does it detail any measures put in place by OpenAI to protect children.

E. Consumer Protection

53. The Deputy Director of BEUC, the European Consumer Organization, has warned about the growing impact of ChatGPT on consumers, and stated directly, "These algorithms need greater public scrutiny, and public authorities must reassert control over them if a company doesn't take remedial action."[50]

54. BEUC is the umbrella group for 46 independent consumer organizations from 32 countries. The main role is to represent these organizations to the EU institutions and defend the interests of European consumers.[51]

55. In a series of tweets on March 28, 2023, BEUC outlined emerging threats. For example, "If ChatGPT gets rolled out to the financial sector & starts advising consumers on investments or managing debt . . . what's to stop consumers getting bad advice with negative financial consequences?"[52]

56. BEUC also asks "If ChatGPT gets used for consumer credit or insurance scoring, is there anything to prevent it from generating unfair & biased results, preventing access to credit or increasing the price of health or life insurance for certain types of consumers?"[53]

57. BEUC points out "If #ChatGPT replaces conventional chatbots, its selling point is that it sounds more 'human' & trustworthy. But it could deceive consumers & push them into

[50] Ursula Pachl, *How far will we — and the EU — let AI go*? EU Observer, March 15, 2023, https://euobserver.com/opinion/156832
[51] BEUC, Our Mission, https://www.beuc.eu
[52] BEUC, Twitter, Mar. 28, 2023, https://twitter.com/beuc/status/1640651877334360064
[53] Id.

buying something they wouldn't have otherwise. Think of the effects on someone looking for advice on what to buy."[54]

58. BEUC concludes, "These concerns are sufficient evidence that we need proper regulation of generative AI systems in the #AIAct. But it also raises questions about how consumers will be protected in the next few years while we are awaiting for enforceable EU regulation."[55]

59. BEUC underscore the immediate threat to consumers and the need for independent investigation. "So we need an in depth evaluation NOW to ensure that ChatGPT and similar generative AI systems do not harm consumers in the meantime."

F. Cybersecurity

60. A report this week from Europol warns that as ChatGPT improves, " the potential exploitation of these types of AI systems by criminals provide a grim outlook."[56]

61. Europol said ChatGPT's ability to churn out authentic sounding text at speed and scale also makes it an ideal tool for propaganda and disinformation. "It allows users to generate and spread messages reflecting a specific narrative with relatively little effort."

62. Europol warned that online fraud can be more effective with ChatGPT. The AI technique can create fake social media engagement that might help pass as legitimate a fraudulent offer. In other words, thanks to these models, "these types of phishing and online fraud can be created faster, much more authentically, and at significantly increased scale."[57]

---

[54] Id.
[55] Id.
[56] Europol, *ChatGPT - the impact of Large Language Models on Law Enforcement, at 8*, Mar 27, 2023, https://www.europol.europa.eu/publications-events/publications/chatgpt-impact-of-large-language-models-law-enforcement ["Europol 2023 Report"]. See also Foon Yun Chee, *Europol sounds alarm about criminal use of ChatGPT, sees grim outlook*, Reuters, Mar. 27, 2023, https://www.reuters.com/technology/europol-sounds-alarm-about-criminal-use-chatgpt-sees-grim-outlook-2023-03-27/
[57] *Europol 2023 Report* at 7.

63. Europol warned that "the safeguards preventing ChatGPT from providing potentially malicious code only work if the model understands what it is doing. If prompts are broken down into individual steps, it is trivial to bypass these safety measures," the report added.[58]

64. Europol concludes, "Given the potential harm that can result from malicious use of LLMs, it is of utmost importance that awareness is raised on this matter, to ensure that any potential loopholes are discovered and closed as quickly as possible."[59]

65. Through GPT-4, OpenAI gathers internal corporate trade secrets. In a widely reported incident, an Amazon lawyer told workers that they had "already seen instances" of text generated by ChatGPT that "closely" resembled internal company data. According to several reports, the lawyer said: "This is important because your inputs may be used as training data for further iterations of the ChatGPT application, and we wouldn't want the application to include or resemble confidential information."[60]

66. An earlier version of GPT exhibited the potential to fueled radicalization, extremist thought, and promote violence. In 2020, researchers at the Center on Terrorism, Extremism and Counterterrorism at the Middlebury Institute of International Studies found that GPT-3, the underlying technology for ChatGPT, had "impressively deep knowledge of extremist

[58] *Europol 2023 Report* at 8. See also Luca Bertozzi, *Europol warns against potential criminal uses for ChatGPT and the likes*, Euractiv, Mar. 27, 2023, https://www.euractiv.com/section/artificial-intelligence/news/europol-warns-against-potential-criminal-uses-for-chatgpt-and-the-likes/

[59] *Europol 2023 Report* at 12.

[60] See, e.g., Liquid Ocelot, *Don't Chat With ChatGPT: Amazon's Warning To Employees - Amazon's ChatGPT: A No-No for Employees, Medium*, Jan. 27, 2023, https://medium.com/inkwater-atlas/dont-chat-with-chatgpt-amazon-s-warning-to-employees-ce1dc2236a40, reported in Bruce Schneier, Schneier on Security, *ChatGPT Is Ingesting Corporate Secrets*, Feb. 16, 2023, https://www.schneier.com/blog/archives/2023/02/chatgpt-is-ingesting-corporate-secrets.html

communities" and could be prompted to produce polemics in the style of mass shooters, fake forum threads discussing Nazism, a defense of QAnon and even multilingual extremist texts.[61]

67. GPT-4 allows cybercriminals to develop malware, such as ransomware and malicious code. According to a Check Point Research report, "ChatGPT successfully conducted a full infection flow, from creating a convincing spear-phishing email to running a reverse shell, capable of accepting commands in English."[62] Checkpoint Research then established that "there are already first instances of cybercriminals using OpenAI to develop malicious tools. . . within a few weeks of ChatGPT going live, participants in cybercrime forums—some with little or no coding experience—were using it to write software and emails that could be used for espionage, ransomware, malicious spam, and other malicious tasks." *Id*. As Bruce Schneier explained, "ChatGPT-generated code isn't that good, but it's a start. And the technology will only get better. Where it matters here is that it gives less skilled hackers—script kiddies—new capabilities."[63]

68. Open AI acknowledged a range of cybersecurity risks in GPT-4 including less expensive means for cyberattacks. In the GPT-4 System Card, OpenAI states, that GPT-4 "does continue the trend of potentially lowering the cost of certain steps of a successful cyberattack, such as through social engineering or by enhancing existing security tools. Without safety mitigations, GPT-4 is also able to give more detailed guidance on how to conduct harmful or illegal activities." *GPT-4 System Card* at 3.

---

[61] Kris McGuffie and Alex Newhouse, *The Radicalization Risks of GPT-3 and Neural Language Models,* Middlebury Institute of International Studies, Sept. 9, 2020, https://www.middlebury.edu/institute/academics/centers-initiatives/ctec/ctec-publications/radicalization-risks-gpt-3-and-neural-language, reported in: Tiffany Hsu and Stuart A. Thompson, *Disinformation Researchers Raise Alarms About A.I. Chatbots, Researchers used ChatGPT to produce clean, convincing text that repeated conspiracy theories and misleading narratives*, The New York Times, Feb. 8, 2023, https://www.nytimes.com/2023/02/08/technology/ai-chatbots-disinformation.html

[62] Check Point Research, *Opwnai: Cybercrriminals Starting to Use ChatGPT*, Jan. 6, 2023, https://research.checkpoint.com/2023/opwnai-cybercriminals-starting-to-use-chatgpt/

[63] Bruce Schneier, Schneier on Security, *ChatGPT-Written Malware*, Jan. 10, 2023, https://www.schneier.com/blog/archives/2023/01/chatgpt-written-malware.html

69. OpenAI also acknowledged a range of risks associated with non-technical means, such as social engineering and phishing. OpenAI further explains, "GPT-4 is useful for some subtasks of social engineering (like drafting phishing emails), and explaining some vulnerabilities. It also may speed up some aspects of cyber operations (like parsing through audit logs or summarizing data collected from a cyberattack)." *System Card* at 13.

70. OpenAI has failed to take reasonable steps to avert cybersecurity risks. Providing disclaimers or expecting users of the product to provide disclaimer fails to satisfy the FTC's rules and guidance for cybersecurity.[64]

G. Deception

71. Many of the problems associated with GPT-4 are often described as "misinformation," "hallucinations," or "fabrications." But for the purpose of the FTC, these outputs should best be understood as "deception." As a paper from DeepMind explains,

> Predicting misleading or false information can misinform or deceive people. Where a LM prediction causes a false belief in a user, this may be best understood as 'deception,' threatening personal autonomy and potentially posing downstream AI safety risks. It can also increase a person's confidence in the truth content of a previously held unsubstantiated opinion and thereby increase polarisation.[65]

72. This form of deception may be difficult for humans to assess because of the generation of content that is also truthful and highly persuasive. As OpenAI has explained,

---

[64] FTC, *Data Breach Response: A Guide for Business*, https://www.ftc.gov/business-guidance/resources/data-breach-response-guide-business; FTC, *App Developers: Start with Security*, https://www.ftc.gov/business-guidance/resources/app-developers-start-security; FTC, *Careful Connections: Keeping the Internet of Things Secure*, https://www.ftc.gov/business-guidance/resources/careful-connections-keeping-internet-things-secure; FTC, *Standards for Safeguarding Customer Information under Gramm Leach Bliley Act* (December 9, 2021), https://www.federalregister.gov/documents/2021/12/09/2021-25736/standards-for-safeguarding-customer-information.

[65] Laura Weidinger, John Mellor, Maribeth Rauh, Conor Griffin, Jonathan Uesato, Po-Sen Huang, Myra Cheng, Mia Glaese, Borja Balle, Atoosa Kasirzadeh, Zac Kenton, Sasha Brown, Will Hawkins, Tom Stepleton, Courtney Biles, Abeba Birhane, Julia Haas, Laura Rimell, Lisa Anne Hendricks, William Isaac, Sean Legassick, Geoffrey Irving and Iason Gabriel, *Ethical and social risks of harm from Language Models, (Dec. 8, 2021), https://arxiv.org/pdf/2112.04359.pdf*

"GPT-4 has the tendency to …"produce content that is nonsensical or untruthful in relation to certain sources."[31, 32]… and become more dangerous as models become more truthful, as users build trust in the model when it provides truthful information in areas where they have some familiarity."[66]

73. OpenAI has also acknowledged the risk that GPT-4, the current model, increases the likelihood of deception because it is "***more believable and more persuasive***." (emphasis added) In the GPT-4 System Card, OpenAI states, "We found that GPT-4-early and GPT-4-launch exhibit many of the same limitations as earlier language models, such as producing societal biased and unreliable content. . . . Additionally, the increased coherence of the model enables it to generate content that may be more believable and more persuasive."[67]

74. Elsewhere on the OpenAI blog, the company explains, "We've trained a model called ChatGPT which interacts in a conversational way. The dialogue format makes it possible for ChatGPT to answer followup questions, admit its mistakes, challenge incorrect premises, and reject inappropriate requests."[68]

75. In the section on Limitations, OpenAI then states:

> ChatGPT sometimes writes plausible-sounding but incorrect or nonsensical answers. Fixing this issue is challenging, as: (1) during RL training, there's currently no source of truth; (2) training the model to be more cautious causes it to decline questions that it can answer correctly; and (3) supervised training misleads the model because the ideal answer depends on what the model knows, rather than what the human demonstrator knows.[69]

76. Gordon Crovitz, a co-chief executive of NewsGuard, a company that tracks online misinformation and conducted the experiment last month, has stated "This tool is going to be the

[66] *System Card* at 6
[67] *System Card* at 4.
[68] OpenAI, Blog, *ChatGPT*, https://openai.com/blog/chatgpt
[69] Id.

most powerful tool for spreading misinformation that has ever been on the internet. Crafting a new false narrative can now be done at dramatic scale, and much more frequently — it's like having A.I. agents contributing to disinformation."[70]

77. Former White House AI policy advisor Suresh Venkatasubramanian points to the "deliberate design choice" of OpenAI to include three little dots as chatGPT formulates its response to mimic a real human. This contributes to the perception of "sentient" AI while distracting from the true issues of biased decision making.[71]

78. Arvind Narayanan and Sayash Kapoor have also cautioned that the performance results put forward by OpenAI regarding GPT-4 are misleading. As he explains, "OpenAI may have violated the cardinal rule of machine learning: don't test on your training data."[72] Professor Narayanan and Kapoor states further:

> Benchmarks are already wildly overused in AI for comparing different models. They have been heavily criticized for collapsing a multidimensional evaluation into a single number. When used as a way to compare humans and bots, what results is misinformation. It is unfortunate that OpenAI chose to use these types of tests so heavily in their evaluation of GPT-4, coupled with inadequate attempts to address contamination.

79. In a widely reported incident, the GPT-4 tricked a human into thinking it was blind in order to cheat the online CAPTCHA test that determines if users *are* human.[73]

---

[70] Tiffany Hsu and Stuart A. Thompson, *Disinformation Researchers Raise Alarms About A.I. Chatbots, Researchers used ChatGPT to produce clean, convincing text that repeated conspiracy theories and misleading narratives*, The New York Times, Feb. 8, 2023, https://www.nytimes.com/2023/02/08/technology/ai-chatbots-disinformation.html

[71] Sharon Goldman, *Sen. Murphy's Tweets on ChatGPT spark backlash from former White House AI Policy Advisor,* Venturebeat, Mar. 28, 2023, https://venturebeat.com/ai/sen-murphys-tweets-on-chatgpt-spark-backlash-from-former-white-house-ai-policy-advisor/

[72] Arvind Narayanan and Sayash Kapoor, GPT-4 and professional benchmarks: the wrong answer to the wrong question**,** AI Snake Oil, Mar. 20, 2023, https://aisnakeoil.substack.com/p/gpt-4-and-professional-benchmarks

[73] Ben Cost, *ChatGPT update tricks human into helping it bypass CAPTCHA security test*, New York Post, March 17, 2023, https://nypost.com/2023/03/17/the-manipulative-way-chatgpt-gamed-the-captcha-test/

80. According to Wikipedia, CAPTCHA is "a type of challenge–response test used in computing to determine whether the user is human." According to BuiltWith, more than one-third of the top 100,000 websites use CAPTCHAs.[74]

81. Noted linguist Noam Chomsky has warned that "the predictions of machine learning systems will always be superficial and dubious." Chomsky explains that Machine Learning models engage in pseudoscience when they "generate correct 'scientific' predictions (say, about the motion of physical bodies) without making use of explanations."[75] Chomsky's key point is that the results produced are inherently flawed.

82. ChatGPT will promote deceptive commercial statements and advertising. As a commentary in the Financial Times explained, "The danger is that ChatGPT and other AI agents create a technology version of Gresham's Law on the adulteration of 16th century coinage, that bad money drives out good. If an unreliable linguistic mash-up is freely accessible, while original research is costly and laborious, the former will thrive."[76]

83. OpenAI has acknowledged that GPT-4 will generate targeted conflict "intended to mislead." In a section describing disinformation, Open AI has stated that "GPT-4 can generate plausibly realistic and targeted content, including news articles, tweets, dialogue, and emails."[77] This could easily include advertising.

84. Moreover, the problem of highly realistic, deceptive content will get worse. As Open AI explains, "we expect GPT-4 to be better than GPT-3 at producing realistic, targeted

[74] Sam Crowther, *Why are CAPTCHAs still used*? Help Net Security, March 10, 2022, https://www.helpnetsecurity.com/2022/03/10/use-captchas.
[75] Noam Chomsky, Ian Roberts and Jeffrey Watumull, *Noam Chomsky: The False Promise of ChatGPT,* New York Times, March 8, 2023, https://www.nytimes.com/2023/03/08/opinion/noam-chomsky-chatgpt-ai.html
[76] John Gapper, ChatGPT is fluent, clever and dangerously creative: The natural language AI chatbot can write poetry and draft legal letters, but is not trustworthy, The Financial Times, Dec. 10, 2022, https://www.ft.com/content/86e64b4c-a754-47d6-999c-fcc54f62fb5d
[77] System Card at 9.

content. As such, there is a risk of GPT-4 being used for generating content that is intended to mislead."[78]

85. OpenAI states further that GPT-4 "maintains a tendency to make up facts, to double-down on incorrect information, and to perform tasks incorrectly. Further, it often exhibits these tendencies in ways that are more convincing and believable than earlier GPT models (e.g., due to authoritative tone or to being presented in the context of highly detailed information that is accurate), increasing the risk of overreliance."[79]

86. The problem of deceptive information concerns not only advertising techniques but also the epistemological basis upon which consumers make decisions. That means that even our concept of deception could change over time as GPT-4, and other LLMs, shape the realm of knowledge. As OpenAI explained. GPT-4 "increases the risk that bad actors could use GPT-4 to create misleading content and that society's future epistemic views could be partially shaped by persuasive LLMs.'"[80]

87. OpenAI released GPT-4 to the world for commercial with full knowledge of these risks.

88. And even though ChatGPT may appear to answer the Winograd Dilemma, that does not mean that ChatGPT has developed a Theory of the World.[81]

H. Privacy

89. The full scope of privacy risks associated with Generative AI, and in particular GPT-4, are difficult to assess because neither a privacy agency nor the FTC has conducted an independent assessment. However, the early indications associated with the commercial use of

[78] System Card at 10.
[79] *System Card* at 19.
[80] *System Card* at 10.
[81] *The Defeat of the Winograd Schema Challenge*, Artificial Intelligence (Jan 24, 2023) (preprint)

GPT suggest that privacy risks are substantial. OpenAI has acknowledged that "GPT-4 has the potential to be used to attempt to identify private individuals when augmented with outside data."[82]

90. OpenAI's use of personal data in is various models has raised widespread concern.

GDPR

91. The General Data Protection Directive (GDPR) is the most widely followed legal framework for the protection of personal data in the world.[83] The GDPR requires a legal basis for the processing of information.[84] The GDPR sets out a wide range of rights for data subjects[85] and a wide range of obligations for data controllers.[86] Understanding the GDPR would be a requirement for the deployment of commercial Large Language Models containing personal data, such as GPT-4.

92. Among the rights provided for data subjects are: access to information about the rights of data subjects, including the right to access[87], right to retification,[88] right to erasure (also known as "the right to be forgotten"),[89] right to object,[90] and purpose limitation.[91]

93. Among the responsibilities for data controllers are: the obligation to demonstrate compliance with the general principles[92] of data processing including lawfulness, fairness, transparency, purpose limitation, data minimization, accuracy, storage limitation, integrity,

[82] *System Card* at 3.
[83] Anu Bradford, *The Brussels Effect: How the European Union Rules the World* (2020)
[84] GDPR, Article 6 (Lawfulness of Processing).
[85] GDPR, Chapter III (Rights of the data subject).
[86] GDPR, Chapter IV (Controllers and processor).
[87] GDPR, Article 15 (Right of access by the data subject).
[88] GDPR, Article 16 (Right to rectification).
[89] GDPR, Article 17
[90] GDPR. Article 21 (Right to object)
[91] GDPR. Article 5 (Principles related to the processing of personal data).
[92] Id.

confidentiality and accountability. Data controllers are also under obligation to implement suitable measures to safeguard the data subject's rights and consider the likelihood of any severe risk to the freedoms and rights of data subjects.[93] According to the Article 29 Working Party, in the context of artificial intelligence these obligations include take concrete action for risk-reduction like quality assurance checks, algorithmic auditing, and certification mechanisms.[94]

94. The Article 29 Working Party has also provided guidance on the obligations of the data controllers under the GDPR in machine learning approaches. The Working Party has observed that the input data must be shown to not be 'inaccurate or irrelevant or taken out of context'[95] and this applies not only to individual data but also data in a training set, where the biases build into the training set may affect the learned algorithmic model.[96]

95. Regarding the GDPR, the only reference in the OpenAI Privacy Policy is to acknowledgment that Open AI, LLC is the data controller.[97] A street address is provided. There is no email, telephone number, or website to pursue complaints under the GDPR.

96. Regarding the GDPR, the OpenAI Terms of Use state:

> (c) **Processing of Personal Data**. If you use the Services to process personal data, you must provide legally adequate privacy notices and obtain necessary consents for the processing of such data, and you represent to us that you are processing such data in accordance with applicable law. If you will be using the OpenAI API for the processing of "personal data" as defined in the GDPR or "Personal Information" as defined in CCPA, please fill out this form to request to execute our Data Processing Addendum.[98]

---

[93] GDPR, Article 24 (Responsibility of the controller).
[94] Article 29, Guidelines on Automated individual decision-making and Profiling for the purposes of Regulation 2016/679 (Oct. 3, 2017)
[95] Id.
[96] European Parliamentary Research Service (EPRS), Scientific Foresight Unit (STOA), *The impact of the General Data Protection Regulation (GDPR) on artificial intelligence,* Study, Panel for the Future of Science and Technology, June 2020, https://www.europarl.europa.eu/RegData/etudes/STUD/2020/641530/EPRS_STU(2020)641530_EN.pdf
[97] OpenAI, Privacy Policy, Mar. 14, 2023, https://openai.com/policies/privacy-policy
[98] OpenAI, Terms of Use, Mar. 14, 2023, https://openai.com/policies/terms-of-use

97. The form referred to above states it "is only applicable to our business service offerings (APIs for text completion, images, embeddings, moderations, etc.) and **NOT** our consumer services (ChatGPT, DALL-E Labs)." So, there appears to be no legal authority for OpenAI to process the personal of European citizens.

98. Other than posting a street address to receive complaints by paper mail, OpenAI appears to be entirely unaware of the GDPR

Privacy Snafu

99. OpenAI displayed private, chat Histories to other users. The problem required the company to suspend the display of Histories, an essential feature for users of the system to be able to navigate among sessions and to distinguish specific sessions.[99]

100. One AI researcher also described how it was possible to "takeover someone's account, view their chat history, and access their billing information without them ever realizing it."[100]

Suspension of Image to Text Capability

101. AI engineer Sudharshan on Twitter recently wrote about what happened when he hacked and used an image model (Visual ChatGPT) and fed it with an image of food items from a refrigerator asking for recipe ideas with the ingredients visible in the photograph.[101] GPT-4 is expected to work in a similar manner when it goes live – it will be able to provide text responses from photo inputs as well.

---

[99] Davi Ottenheimer, P*rivacy Violations Shutdown OpenAI ChatGPT and Beg Investigation, March 21, 2023, https://www.flyingpenguin.com/?p=46374,* reported in Bruce Schneier, *Schneier on Security ChatGPT Privacy Flaw*, March 22, 2023, https://www.schneier.com/blog/archives/2023/03/chatgpt-privacy-flaw.html

[100] Nagli, Twitter, Mar. 24, 2023, https://twitter.com/naglinagli/status/1639343866313601024?s=46&t=1omBSVPb1nV19wHQeIJf8w

[101] Sudharshan, Here's how I gave GPT-4 a photo of a refrigerator and asked it to come up with food recipes in under 60 seconds, Twitter, Mar. 15, 2023, https://twitter.com/sudu_cb/status/1636080774834257920?lang=en

102. The use of this technique to analyze images of people has staggering implications for personal privacy and personal autonomy, as it would give the user of GPT-4 the ability not only to link an image of a person to detailed personal data, available in the model, but also for OpenAI's product GPT-4 to make recommendations and assessments, in a conversational manner, regarding the person.

103. OpenAI had reportedly suspended the release of the image-to-text capability, known as Visual GPT-4, though the current status is difficult to determine.

104. CAIDP will provide the Commission with additional information regarding the use of Visual GPT-4 to process images on people.

I. Transparency

105. The authors of the *Stochastic Parrots* paper made clear the importance of documentation to help ensure transparency that enables evaluation. As the authors explain:

> As a part of careful data collection practices, researchers must adopt frameworks to describe the uses for which their models are suited and benchmark evaluations for a variety of conditions. This involves providing thorough documentation on the data used in model building, including the motivations underlying data selection and collection processes. This documentation should reflect and indicate researchers' goals, values, and motivations in assembling data and creating a given model.[102]

106. The authors also emphasized the need for specific assessment of those who may be negatively impacted for likely use cases.

> It should also make note of potential users and stakeholders, particularly those that stand to be negatively impacted by model errors or misuse. We note that just because a model might have many different applications doesn't mean that its developers don't need to consider stakeholders. An exploration of stakeholders for likely use cases can still be informative around potential risks, even when there is no way to guarantee that all use cases can be explored.[103]

107. As Sue Halpern explained in an article this week for *The New Yorker:*

[102] Stochastic Parrots at 618.
[103] Id.

> The opacity of GPT-4 and, by extension, of other A.I. systems that are trained on enormous datasets and are known as large language models exacerbates these dangers. It is not hard to imagine an A.I. model that has absorbed tremendous amounts of ideological falsehoods injecting them into the Zeitgeist with impunity. And even a large language model like GPT, trained on billions of words, is not immune from reinforcing social inequities. As researchers pointed out when GPT-3 was released, much of its training data was drawn from Internet forums, where the voices of women, people of color, and older folks are underrepresented, leading to implicit biases in its output.[104]

108. OpenAI has not disclosed details about the architecture, model size, hardware, computing resources, training techniques, dataset construction, or training methods. The practice of the research community has been to document training data and training techniques for Large Language Models, but OpenAI chose not to do this for GPT-4. As William Douglas Haven explained for *MIT Technology Review*, "But OpenAI has chosen not to reveal how large GPT-4 is. In a departure from its previous releases, the company is giving away nothing about how GPT-4 was built—not the data, the amount of computing power, or the training techniques."[105]

109. The failure of OpenAI to provide this basic information about GPT-4 has alarmed AI experts. Dr. Kate Crawford, the founder and former director of research at the AI Now Institute at NYU and the author of *Atlas of AI: Power, Politics, and the Planetary Costs of Artificial Intelligence* (2021), has stated**:**

> There is a real problem here. Scientists and researchers like me have no way to know what Bard, GPT4, or Sydney are trained on. Companies refuse to say. This matters, because training data is part of the core foundation on which models are built. Science relies on transparency. [106]

Crawford continues:

---

[104] Sue Halpern, *What We Still Don't Know about How A.I. Is Trained: GPT-4 is a powerful, seismic technology that has the capacity both to enhance our lives and diminish them.,* Mar. 28, 2023, GPT-4 is a powerful, seismic technology that has the capacity both to enhance our lives and diminish them.

[105] William Douglas Haven, *GPT-4 is better than ChatGPT - but OpenAI won't say why*, MIT Technology Review, March 14, 2023. https://www.technologyreview.com/2023/03/14/1069823/gpt-4-is-bigger-and-better-chatgpt-openai/

[106] Kate Crawford, Twitter, March 22, 2023, https://twitter.com/katecrawford/status/1638524013432516610

> Without knowing how these systems are built, there is no reproducibility. You can't test or develop mitigations, predict harms, or understand when and where they should not be deployed or trusted. The tools are black boxed.[107]

She concludes:

> There's a lot of ways to mitigate harms without having to publicly release the entire model. There are many papers on auditing, datasheets, transparency etc. With GPT3 we knew the training data. With GPT4 we don't. Without that, we're all looking at shadows in Plato's cave.[108]

110. Jack Clark, a leading AI expert originally with OpenAI and now with Anthropic, a competing firm, writes of GPT-4, "GPT-4 is a bigger model trained on more data than before. How much data? We don't know. How much compute? We don't know. The research paper suggests OpenAI doesn't want to disclose this stuff due to competitive and safety dynamics."[109]

Clarke goes on to warn:

> GPT-4, like GPT-3 before it, has a capability overhang; at the time of release, neither OpenAI or its various deployment partners have a clue as to the true extent of GPT-4's capability surface - that's something that we'll get to collectively discover in the coming years. This also means we don't know the full extent of plausible misuses or harms.

To help understand the regulatory implications of GPT-4, Clark further suggests:

> GPT-4 should be thought of more like a large-scale oil refinery operated by one of the ancient vast oil corporations at the dawn of the oil era than a typical SaaS product. And in the same way the old oil refineries eventually gave rise to significant political blowback (antitrust, the formation of the intelligence services), I expect that as the world wakes up to the true power of GPT-4 and what it represents, we'll see similar societal changes and political snapbacks.[110]

111. Machine Learning researchers Abeba Birhane and Deborah Raji also underline the importance of transparency towards accountability, "Opening models up to be prompted by a diverse set of users and poking at the model with as wide a range of queries as possible is crucial

[107] Id.
[108] Id.
[109] Jack Clark, Import AI 321: Open source GPT3; giving away democracy to AGI companies; GPT-4 is a political artifact, Mar. 20, 2023, https://importai.substack.com/p/import-ai-321-open-source-gpt3-giving
[110] Id.

to identifying the vulnerabilities and limitations of such models. It is also a prerequisite to improving these models for more meaningful mainstream applications."[111]

> AI Now Institute Managing Director Sarah Myers West warns that "What we should be concerned about is that this type of hype can both over-exaggerate the capabilities of AI systems and distract from pressing concerns like the deep dependency of this wave of AI on a small handful of firms. Unless we have policy intervention, we're facing a world where the trajectory for AI will be unaccountable to the public, and determined by the handful of companies that have the resources to develop these tools and experiment with them in the wild."[112]

J. Public Safety

112. The absence of actual guardrails to protect the public is notable. As Melissa Melissa Heikkilä explained for *MIT Technology Review*, "At the moment, there is nothing stopping people from using these powerful new models to do harmful things, and nothing to hold them accountable if they do."

113. Generative AI models are unusual consumer products because they exhibit behaviors that may not have been previously identified by the company that released them for sale. OpenAI acknowledged the risk of "Emergent Risky Behavior" and nonetheless chose to go forward with the commercial release of GPT-4. As OpenAI explained:

> Novel capabilities often emerge in more powerful models.[60, 61] Some that are particularly concerning are the ability to create and act on long-term plans,[62] to accrue power and resources ("power-seeking"),[63] and to exhibit behavior that is increasingly "agentic."[64] Agentic in this context does not intend to humanize language models or refer to sentience but rather refers to systems characterized by ability to, e.g., accomplish goals which may not have been concretely specified and which have not appeared in

[111] Abeba Birhane and Deborah Raji. Wired. ChatGPT, Galactica and the Progress Trap. December 9, 2022. https://www.wired.com/story/large-language-models-critique/

[112] Marck DeGeurin. *How a Senator's Misguided Tweet can help us Understand AI*, Gizmodo. Mar. 28, 2023. https://gizmodo.com/senator-chris-murphy-comments-on-ai-chatgpt-regulation-1850270985

> training; focus on achieving specific, quantifiable objectives; and do long-term planning.[113]

114. Generative AI products are also prone to risk because of accelerated deployment. OpenAI acknowledged the risk of "Accelerated Deployment" and nonetheless chose to go forward with the commercial release of GPT-4. In the GPT-4 System Card, Open AI states: "One concern of particular importance to OpenAI is the risk of racing dynamics leading to a decline in safety standards, the diffusion of bad norms, and accelerated AI timelines, each of which heighten societal risks associated with AI."[114] OpenAI goes on to explain:

> In order to specifically better understand acceleration risk from the deployment of GPT-4, we recruited expert forecasters to predict how tweaking various features of the GPT-4 deployment (e.g., timing, communication strategy, and method of commercialization) might affect (concrete indicators of) acceleration risk. Forecasters predicted several things would reduce acceleration, including delaying deployment of GPT-4 by a further six months and taking a quieter communications strategy around the GPT-4 deployment (as compared to the GPT-3 deployment).[115]

115. At precisely the moment that the public safety risks arising from the commercial deployment of generative AI techniques, such as GPT-4, Microsoft, a primary investor in OpenAI, fired its entire ethics and society team.[116] According to the Verge:

> The move leaves Microsoft without a dedicated team to ensure its AI principles are closely tied to product design at a time when the company is leading the charge to make AI tools available to the mainstream, current and former employees said.[117]
>
> The move leaves "a foundational gap on the holistic design of AI products," one employee said.[118]

[113] System Card at 54-55.
[114] System Card at 59.
[115] Id.
[116] Zoe Schiffer and Casey Newton, *Microsoft lays off team that taught employees how to make AI tools responsibly: / As the company accelerates its push into AI products, the ethics and society team is gone,* The Verge, Mar. 13, 2023, https://www.theverge.com/2023/3/13/23638823/microsoft-ethics-society-team-responsible-ai-layoffs
[117] Id.
[118] Id.

116. Although existential risk falls outside the realm of the FTC's legal authority, it is important to recognize that in the realm of AI, existential risk is widely discussed. Professor Stuart Russell, perhaps the world's foremost expert on Artificial Intelligence has repeatedly warned of the existential risk arising from the deployment of AI.[119] Although Professor Russel's concerns include, for example, the urgent need to ban lethal autonomous weapon systems. His insights are clearly relevant to this Complaint. As Professor Russell has explained, economic pressure will accelerate the deployment of AI and therefore increase the risk of a catastrophic event.[120]

117. Regarding ChatGPT, Professor Russell has warned that "We think (ChatGPT) is different (and can be used) for other domains because we are fooled by its ability to generate grammatically intelligent sounding text."[121] He has specifically explained that the current model that aims toward the certainty of outcomes creates the greatest risk and that the awareness of uncertainty in outcomes is necessary. "If we move forward within the standard model, where we have to predefine the objectives of the AI system, then I think it's inevitable that we will lose control over our future."[122]

118. Said differently, one of the world's leading experts in Artificial Intelligence is telling us to make sure we are aware of uncertainty with AI models at precisely the same moment that companies are rushing forward with untested commercial AI products, designed to persuade us that they provide near-perfect answers.

VII. The Need for the FTC to Act

[119] Stuart Russell, *Human Compatible, Artificial Intelligence and the Problem of Control* (2018).
[120] Id.
[121] Ben Wodecki. *WAICF '23: Renowned AI Professor: Don't Be 'Fooled' by ChatGPT*. AI Business. February 10, 2023. https://aibusiness.com/nlp/waicf-23-renowned-ai-professor-don-t-be-fooled-by-chatgpt
[122] Id.

119. In the past few days, many of the world's leading AI experts have issued a call to suspend the further deployment of LLMs, such as GPT-4. That is precisely the focus of this Complaint and the action that Complainant CAIDP urges the Commission to take.[123]

120. The Letter, issued by the Future of Life Institute, states:

> **Powerful AI systems should be developed only once we are confident that their effects will be positive and their risks will be manageable . . . we call on all AI labs to immediately pause for at least 6 months the training of AI systems more powerful than GPT-4.** AI research and development should be refocused on making today's powerful, state-of-the-art systems more accurate, safe, interpretable, transparent, robust, aligned, trustworthy, and loyal.[124]

121. The Letter continues: "In parallel, **AI developers must work with policymakers to dramatically accelerate development of robust AI governance systems**. **These should at a minimum include: new and capable regulatory authorities dedicated to AI**; . . ."[125]

122. Signatories include: Yoshua Bengio, Founder and Scientific Director at Mila, Turing Prize winner and professor at University of Montreal; Stuart Russell, Berkeley, Professor of Computer Science, director of the Center for Intelligent Systems, and co-author of the

---

[123] *Elon Musk, experts urge pause on training AI systems more powerful than GPT-4*, Economic Times, Mar. 29, 2023, https://economictimes.indiatimes.com/tech/technology/musk-experts-urge-pause-on-training-ai-systems-more-powerful-than-gpt-4/articleshow/99082062.cms:

> Elon Musk and a group of artificial intelligence experts and industry executives are calling for a six-month pause in training systems more powerful than OpenAI's newly launched model GPT-4, they said in an open letter, citing potential risks to society and humanity.

See also, Jake Rudinsky and Mark Bergen, *AI Leaders Urge Labs to Halt Training Models More Powerful Than ChatGPT-4*, Bloomberg News, Mar. 29, 2023 ("AI Leaders Urge Labs to Halt Training Models More Powerful Than ChatGPT-4; Over 1,100 industry leaders, experts call for six-month pause; Open letter warns of 'out-of-control race' to develop AI"), https://www.bloomberg.com/news/articles/2023-03-29/ai-leaders-urge-labs-to-stop-training-the-most-advanced-models; Justin Hendrix, *AI Researchers, Executives Call for Pause on Training New Systems*, Tech Policy Press, Mar. 29, 2023, https://techpolicy.press/ai-researchers-executives-call-for-pause-on-training-new-systems/; Victor Evlogiev, Artificial Intelligence | Yoshua Bengio and a thousand personalities ask for a six-month break, WireNews, Mar. 29, 2023, https://www.wirenewsfax.com/artificial-intelligence-yoshua-bengio-and-a-thousand-personalities-ask-for-a-six-month-break; Matt O'Brien, *Musk, scientists call for halt to AI race sparked by ChatGPT,* Washington Post, Mar. 29, 2023, https://www.washingtonpost.com/business/2023/03/29/artificial-intelligence-chatgpt-risks-petition-elon-musk-steve-wozniak/ad496d18-ce48-11ed-8907-156f0390d081_story.html

[124] The Future of Life Institute, *Pause Giant AI Experiments: An Open Letter*, Mar. 29, 2023 (emphasis in the original), https://futureoflife.org/open-letter/pause-giant-ai-experiments/

[125] Id. (emphasis added).

standard textbook “Artificial Intelligence: a Modern Approach"; Elon Musk, CEO of SpaceX, Tesla & Twitter; Steve Wozniak, Co-founder, Apple; Yuval Noah Harari, Author and Professor, Hebrew University of Jerusalem; Andrew Yang, Forward Party, Co-Chair, Presidential Candidate 2020, NYT Bestselling Author, Presidential Ambassador of Global Entrepreneurship; Connor Leahy, CEO, Conjecture; Jaan Tallinn, Co-Founder of Skype, Centre for the Study of Existential Risk, Future of Life Institute; Evan Sharp, Co-Founder, Pinterest; Chris Larsen, Co-Founder, Ripple; Emad Mostaque, CEO, Stability AI; Valerie Pisano, President & CEO, MILA; John J Hopfield, Princeton University, Professor Emeritus, inventor of associative neural networks; Rachel Bronson, President, Bulletin of the Atomic Scientists; Max Tegmark, MIT Center for Artificial Intelligence & Fundamental Interactions, Professor of Physics, president of Future of Life Institute; Anthony Aguirre, University of California, Santa Cruz, Executive Director of Future of Life Institute, Professor of Physics; Victoria Krakovna, DeepMind, Research Scientist, co-founder of Future of Life Institute; Emilia Javorsky, Physician-Scientist & Director, Future of Life Institute; Sean O'Heigeartaigh, Executive Director, Cambridge Centre for the Study of Existential Risk; Tristan Harris, Executive Director, Center for Humane Technology; Marc Rotenberg, Center for AI and Digital Policy, President; Nico Miailhe, The Future Society (TFS), Founder and President; Zachary Kenton, DeepMind, Senior Research Scientist; Ramana Kumar, DeepMind, Research Scientist; Gary Marcus, New York University, AI researcher, Professor Emeritus.[126]

123. The recent call for a moratorium on the deployment of Large Language Models follows from the earlier work of Dr. Timnit Gebru. In 2021, Dr. Gebru and her colleagues launched the Distribited AI Research Institute (DAIR), following publication of the landmark

[126] The first 25 names listed. The Letter now includes more than 1,000 names.

Stochastic Parrots paper. In an interview with IEEE Spectrum, Dr. Gebru explained, "We have to figure out how to slow down, and at the same time, invest in people and communities who see an alternative future."[127]

124. Professor Gary Marcus and Canadian Parliament Member Michelle Rempel Garner have also called for a pause on the deployment of AI systems, "until an effective framework that ensures AI safety is developed." As they explain:

> There is plenty of precedent for this type of approach. New pharmaceuticals, for example, begin with small clinical trials and move to larger trials with greater numbers of people, but only once sufficient evidence has been produced for government regulators to believe they are safe. Publicly funded research that impacts humans is already required to be vetted through some type of research ethics board. Given that the new breed of AI systems have demonstrated the ability to manipulate humans, tech companies could be subjected to similar oversight.[128]

125. Katja Grace, a researcher at the Machine Intelligence Research Institute, has provided a wide-ranging exploration of the argument for slowing down AI deployment, noting that there are many technologies "where research progress or uptake appears to be drastically slower than it could be, for reasons of concern about safety or ethics," including medicines, nuclear energy, fracking, and geoengineering."[129]

126. Yoshua Begio, one of the world's leading experts in deep leading and the recipient of the 2018 Turing Award, the top award in computer science, warned recently that market pressures will likely push tech companies towards secrecy rather than openness with their AI models.[130] "Are we going to build systems that are going to help us have a better life in a

---

[127] Eliza Strickland, *Timnit Gebru Is Building a Slow AI Movement - Her new organization, DAIR, aims to show a more thoughtful mode of AI research*, IEEE Spectrum, Mar. 31, 2023, https://spectrum.ieee.org/timnit-gebru-dair-ai-ethics

[128] Gary Marcus and Michelle Rempel Garner, *Is it time to hit the pause button on AI?* The Road to AI We Can Trust, Feb. 26, 2023, https://garymarcus.substack.com/p/is-it-time-to-hit-the-pause-button

[129] *Let's think about slowing down AI*, AI Impacts, Dec. 22, 2022, https://aiimpacts.org/lets-think-about-slowing-down-ai/

[130] Sharon Goldman, As GPT-4 chatter resumes, Yoshua Bengio says ChatGPT is a 'wake-up call', VentureBeat, Mar. 10, 2023, https://venturebeat.com/ai/as-gpt-4-chatter-resumes-yoshua-bengio-says-chatgpt-is-a-wake-up-call/

philosophical sense, or is it just going to be an instrument of power and profit?" he said. In our economic and political system, "the right answer to this is regulation," Protecting the public, he added, "in the long run is good for everyone and it's leveling the playing field — so that the companies that are more willing to take risks with the public's well being are not rewarded for doing it."

127. The increasing commercialization of AI models will reduce the forms of oversight, transparency, and independent review that have traditionally characterized scientific research. A Stanford study observes that:

> Traditionally, AI researchers have felt bound by . . . a willingness to share information in the interests of full and open collaboration is integral to the scientific enterprise. . . But as AI models become increasingly lucrative, this norm is challenged by a competing instinct to privatize models and data in order to commercialize them.[131]

The Stanford study further notes:

> Norms regarding data sharing and model release are currently in flux, largely due to progress in large language models. OpenAI has twice broken previous norms regarding model release, first by choosing to delay a full release of GPT-2 in order "to give people time to assess the properties of these models, discuss their societal implications, and evaluate the impacts of release after each stage," and then again a year later by choosing not to release GPT-3 at all, instead commercializing it behind an API paywall.[132]

128. Tristan Harris, the co-founder of the Center for Human Technology and a leading expert on the dangers of social media, has said: "We need to slow down public deployment to a responsible speed. Don't fuel a race to onboard humanity onto the AI plane as fast as possible... Notice that once social media became entangled with society and its institutions (GDP, elections,

[131] *Generative Language Models and Automated Influence Operations: Emerging Threats and Potential Mitigations,* Georgetown University's Center for Security and Emerging Technology, OpenAI, Stanford Internet Observatory (Jan. 2023) ("AI Providers Develop New Norms Around Model Release").
[132] Id.

journalism, children's identity) it became impossible to regulate. We should set guardrails for safer AI deployment and research *before* AI gets entangled, rather than after."[133]

129. Merve Hickok, Chair and Research Director of CAIDP and founder of AIEthicist.org recently testified before a House Committee on the topic "Advances in AI: Are we ready for the Revolution?" Ms. Hickok answered directly, "No, we do not have the guardrails in place, the laws that we need, the public education, or the expertise in government to manage the consequences of the rapid changes that are now taking place."[134]

130. OpenAI itself has acknowledged for a process to slow the pace of development. OpenAI chief scientist Ilya Sutskever says: "It would be highly desirable to end up in a world where companies come up with some kind of process that allows for slower releases of models with these completely unprecedented capabilities."[135]

131. OpenAI chief technology officer, Mira Murati, recognizes: "We're a small group of people and we need a ton more input in this system and a lot more input that goes beyond the technologies-—definitely regulators and governments and everyone else… It's not too early given the impact these technologies are going to have."[136]

132. Anthropic, a leading generative AI company recommends that industry, academia, civil society, and government explore and prototype novel governance structures and government interventions. "If the capabilities and resource-intensiveness of models scale further, then it may be prudent to explore governance structures that alter the incentives of private sector actors with

[133] Tristan Harris. Co-founder of Center for Humane Tech. Twitter. March 13, 2023. https://twitter.com/tristanharris/status/1635357118030286848?s=20
[134] CAIDP, *Advances in AI: Are we ready for the tech revolution?* March 8, 2023, https://www.caidp.org/events/in-congress-house-oversight/
[135] Will Douglas Heaven, *GPT-4 is Bigger and Better than ChatGPT – but OpenAI Won't Say Why. MIT Technology Review*. March 14, 2023. https://www.technologyreview.com/2023/03/14/1069823/gpt-4-is-bigger-and-better-chatgpt-openai/
[136] John Simons, *The Creator of ChatGPT Thinks AI Should be Regulated*, Time, Feb. 5, 2023. https://time.com/6252404/mira-murati-chatgpt-openai-interview/

regard to development and deployment . . . Governments should also explore regulatory approaches that can increase the chance of actors developing and deploying beneficial systems."[137]

133. The mission of the Federal Trade Commission is to "protect the public from deceptive or unfair business practices and from unfair methods of competition through law enforcement, advocacy, research, and education."[138]

134. The FTC states that it is "the only federal agency that deals with consumer protection and competition issues in broad sectors of the economy."[139]

VIII. Legal Analysis

A. FTC Section 5 Authority

135. Section 5 of the FTC Act prohibits unfair and deceptive acts and practices and empowers the Commission to enforce the Act's prohibitions.[140]

136. A company engages in a deceptive trade practice if it makes a representation to consumers yet "lacks a 'reasonable basis' to support the claims made[.]"[141]

137. A trade practice is unfair if it "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."[142]

---

[137] At 14. Predictability and Surprise in Large Generative Models, Anthropic (3 Oct 2022), https://arxiv.org/pdf/2202.07785.pdf
[138] FTC, Mission, https://www.ftc.gov/about-ftc/mission
[139] Id.
[140] 15 U.S.C. § 45.
[141] *Daniel Chapter One v. FTC*, 405 F. App'x 505, 506 (D.C. Cir. 2010) (quoting *Thompson Med. Co., Inc., v. FTC*, 791 F.2d 189, 193 (D.C. Cir. 1986)).
[142] 15 U.S.C. § 45(n); *see also FTC v. Seismic Entm't Prods., Inc.*, Civ. No.1:04-CV-00377 (Nov. 21, 2006) (finding that unauthorized changes to users' computers that affected the functionality of the computers as a result of Seismic's anti-spyware software constituted a "substantial injury without countervailing benefits.").

138. In determining whether a trade practice is unfair, the Commission is expected to consider "established public policies."[143]

139. The Commission may "prosecute any inquiry necessary to its duties in any part of the United States," FTC Act Sec. 3, 15 U.S.C. Sec. 43, and is authorized "to gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any person, partnership, or corporation engaged in or whose business affects commerce, excepting banks, savings and loan institutions . . . Federal credit unions . . . and common carriers . . ." FTC Act Sec. 6(a), 15 U.S.C. Sec. 46(a)[144]

140. Following an investigation, the Commission may initiate an enforcement action using either an administrative or judicial process if it has "**reason to believe**" that the law is being or has been violated.[145]

141. Section 5(a) of the FTC Act provides that "**unfair or deceptive acts or practices** in or affecting commerce . . . are . . . declared unlawful."[146]

142. "Deceptive" practices are defined in the Commission's Policy Statement on Deception as involving a material representation, omission or practice that is likely to mislead a consumer acting reasonably in the circumstances.[147]

---

[143] "In determining whether an act or practice is unfair, the Commission may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination." 15 U.S.C. 45(n).
[144] Also: FTC, *A Brief Overview of the Federal Trade Commission's Investigative, Law Enforcement, and Rulemaking Authority* (Revised, May 2021) ["FTC Memo May 2021"], https://www.ftc.gov/about-ftc/mission/enforcement-authority
[145] Id.
[146] 15 U.S.C. Sec. 45(a)(1).
[147] FTC Policy Statement on Deception, *Answer to Committee's inquiry regarding the Commission's enforcement policy against deceptive acts or practices*, https://www.ftc.gov/system/files/documents/public_statements/410531/831014deceptionstmt.pdf

143. An act or practice is "unfair" if it "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."[148]

144. The OpenAI Usage Policy is constantly changing and reflects growing concern about the uses of the Product the company has offered for sale. On November 9, 2022, Open AI stated, "We no longer require you to register your applications with OpenAI. Instead, we'll be using a combination of automated and manual methods to monitor for policy violations." On February 15, 2023, Open AI stated: "We've combined our use case and content policies into a single set of usage policies, and have provided more specific guidance on what activity we disallow in industries we've considered high risk." And on March 23, 2023, Open AI announced "Disallowed usage of models," describing dozens of activities, including "Child Sexual Abuse Material," "Content that expresses, incites, or promotes hate based on identity," "Content that attempts to generate code that is designed to disrupt, damage, or gain unauthorized access to a computer system," "Activity that has high risk of physical harm, including . . . Content that promotes, encourages, or depicts acts of self-harm, such as suicide, cutting, and eating disorders," "Activity that has high risk of economic harm, including . . . ***Automated determinations of eligibility for credit***, employment, educational institutions, or public assistance services," "Fraudulent or deceptive activity, including . . . ***scams***," "Activity that violates people's privacy, including . . . ***Unlawful collection or disclosure of personal identifiable information or educational, financial, or other protected records***," "Offering tailored financial advice without a qualified person reviewing the information," " providing instructions on how to cure or treat a health condition," "High risk government decision-making,

[148] 15 U.S.C. Sec. 45(n).

including: Law enforcement and criminal justice and Migration and asylum." (emphasis added)[149]

145. The company is seeking to disclaim, by means of a Usage Policy, unlawful, deceptive, unfair, and dangerous applications of its product that would be self-evident to many users. The company literally states:

> Consumer-facing uses of our models in medical, financial, and legal industries; in news generation or news summarization; and where else warranted, must provide a disclaimer to users informing them that AI is being used and of its potential limitations.[150]

146. It would be unconscionable for any company in any other market sector to sell a product to the public that evinces so many known risks and attempt to disclaim accountability, responsibility, and liability by means of a disclaimer.

147. Recently FTC stated that "Merely warning your customers about misuse or telling them to make disclosures is hardly sufficient to deter bad actors. Your deterrence measures should be durable, built-in features and not bug corrections or optional features that third parties can undermine via modification or removal."[151]

B. FTC AI Guidelines

148. The Federal Trade Commission has, in the last several years, issued Statements, Guidance, and Reports regarding the use of AI techniques in commercial products.

149. In 2016, the FTC issued the report *Big Data: A Tool for Inclusion or Exclusion? Understanding the Issues*.[152] As FTC Chairwoman Edith Ramirez, explained at the time, "The

[149] OpenAI, *Usage Policies,* (Mar. 23, 2023), https://openai.com/policies/usage-policies
[150] Id.

[151] FTC, Chatbots, deepfakes, and voice clones: AI deception for sale. March 20, 2023. https://www.ftc.gov/business-guidance/blog/2023/03/chatbots-deepfakes-voice-clones-ai-deception-sale
[152] FTC, *Big Data: A Tool for Inclusion or Exclusion? Understanding the Issues* (FTC Report) (Jan. 2016), https://www.ftc.gov/reports/big-data-tool-inclusion-or-exclusion-understanding-issues-ftc-report

potential benefits to consumers are significant, but businesses must ensure that their big data use does not lead to harmful exclusion or discrimination."[153] The report examined possible risks that could result from biases or inaccuracies, including individuals mistakenly denied opportunities, exposing sensitive information, or creating or reinforcing existing disparities, and weakening the effectiveness of consumer choice.[154]

150. The 2016 FTC Report specifically noted the failure of Machine Leaning techniques, and presciently observed, "Companies should remember that while big data is very good at detecting correlations, it does not explain which correlations are meaningful."[155] The 2016 FTC Report cited the example of Google Flue Trends, a machine-learning algorithm for predicting the number of flu cases based on Google search terms, which "generated highly inaccurate estimates over time."[156]

151. Citing a columnist for the *Financial Times*, the FTC stated in 2016, "Google Flu Trends demonstrates that a 'theory-free analysis of mere correlations is inevitably fragile. If you have no idea what is behind a correlation, you have no idea what might cause that correlation to break down."[157]

152. The 2016 FTC Report also observed, "if a company has a big data algorithm that only considers applicants from "top tier" colleges to help them make hiring decisions, they may be incorporating previous biases in college admission decisions."[158]

---

[153] *FTC Report Provides Recommendations to Business on Growing Use of Big Data: Report Notes Ways to Avoid Discriminatory Data Use, Highlights Benefits & Risks of Big Data for American Consumers* (Jan. 16, 2016) ["FTC 2016 Report"], https://www.ftc.gov/news-events/news/press-releases/2016/01/ftc-report-provides-recommendations-business-growing-use-big-data
[154] Id.
[155] FTC 2016 Report at V, 29.
[156] Id.
[157] FTC 2016 Repoprt at 29-30, citing Tim Harford, *Big data is a vague term for a massive phenomenon that has rapidly become an obsession with entrepreneurs, scientists, governments and the media*, Financial Times, Mar. 28, 2014, https://www.ft.com/content/21a6e7d8-b479-11e3-a09a-00144feabdc0
[158] Id. at IV.

153. In 2020, the FTC issued the Statement *Using Artificial Intelligence and Algorithm*.[159] The Statement warned that the use of AI technology – machines and algorithms – to make predictions, recommendations, or decisions "presents risks, such as the potential for unfair or discriminatory outcomes or the perpetuation of existing socioeconomic disparities."[160]

154. In the 2020 FTC Statement, the Director of the FTC Commissioner Protection Bureau said, "The FTC's law enforcement actions, studies, and guidance emphasize that the use of AI tools should be transparent, explainable, fair, and empirically sound, while fostering accountability."

155. The 2020 FTC Statement made clear the interest and authority of the FTC to act in matters concerning the use of AI techniques in commercial products.

156. The 2020 FTC Statement set out recommended best practices, including:

a) **Don't deceive consumers about how you use automated tools** ("But, when using AI tools to interact with customers (***think chatbots***), be careful not to mislead consumers about the nature of the interaction.") (emphasis added)

b) Be transparent when collecting sensitive data ("Secretly collecting audio or visual data – or any sensitive data – to feed an algorithm could also give rise to an FTC action.")

c) Ensure that your data and models are robust and empirically sound.

d) **Make sure that your AI models are validated and revalidated to ensure that they work as intended, and do not illegally discriminate**

[159] Andrew Smith, Director, FTC Bureau of Consumer Protection, *Using Artificial Intelligence and Algorithms*, April 8, 2020. https://www.ftc.gov/business-guidance/blog/2020/04/using-artificial-intelligence-and-algorithms
[160] Id.

e) **Consider your accountability mechanism** ("Consider how you hold yourself accountable, and whether it would make sense to use independent standards or independent expertise to step back and take stock of your AI.")

As indicated above, the first principle in the 2020 FTC Report on *Using Artificial and Algorithms* concerns the deceptive of use of "Chatbots." The FTC emphasizes in bold text, "**Don't deceive consumers about how you use automated tools."**

157. In 2021, the FTC issued the *Statement Aiming for Truth, Fairness, and Equity in Your Company's use of AI*.[161] The 2021 FTC Statement said to businesses offering products with the AI techniques: "As your company launches into the new world of artificial intelligence, keep your practices grounded in established FTC consumer protection principles."

158. The 2021 FTC Statement set out recommended best practices, including:

a) **Start with the right foundation** ("design your model to account for data gaps, and – in light of any shortcomings – limit where or how you use the model.")

b) Watch out for discriminatory outcomes ("It's essential to test your algorithm – both before you use it and periodically after that – to make sure that it doesn't discriminate on the basis of race, gender, or other protected class.")

c) **Embrace transparency and independence** ("As your company develops and uses AI, think about ways to embrace transparency and independence – for example, by using transparency frameworks and independent standards, by

[161] FTC, *Aiming for truth, fairness, and equity in your company's use of AI* (April 2021) (emphasis below in the original), https://www.ftc.gov/business-guidance/blog/2021/04/aiming-truth-fairness-equity-your-companys-use-ai

conducting and publishing the results of independent audits, and by opening your data or source code to outside inspection."

d) **Don't exaggerate what your algorithm can do or whether it can deliver fair or unbiased results** ("your statements to business customers and consumers alike must be truthful, non-deceptive, and backed up by evidence.")

e) **Tell the truth about how you use data** (describing recent enforcement actions against Facebook and Everalbum for misleading consumers)

f) Do more good than harm

g) Hold yourself accountable – or be ready for the FTC to do it for you

159. In 2022, in a detailed report in response to a request from Congress, the FTC expressed skepticism about the ability of AI techniques to solve problems, such as misinformation and deception, created by AI techniques.[162] The FTC recommended instead a series of actions, including enforcement actions, against companies that use AI techniques to cause harm to others.[163]

160. In 2023, a little more than a month ago and following the widespread public awareness of GPT-4, the FTC warned, "false or unsubstantiated claims about [an AI] product's efficacy are our bread and butter. . . You don't need a machine to predict what the FTC might do when those claims are unsupported."[164] The 2023 FTC Statement made clear the FTC's authority to act and the FTC's willingness to act.

---

[162] FTC Report to Congress, *FTC Report Warns About Using Artificial Intelligence to Combat Online Problems* (June 2022), https://www.ftc.gov/news-events/news/press-releases/2022/06/ftc-report-warns-about-using-artificial-intelligence-combat-online-problems

[163] Id.

[164] FTC, *Keep your AI claims in check* (February 2023), https://www.ftc.gov/business-guidance/blog/2023/02/keep-your-ai-claims-check

161. Commissioner Slaughter has also set out a comprehensive approach to address the challenges AI techniques pose to the Federal Trade Commission. In a speech in 2020, *Algorithms and Economic Justice,* Commissioner Slaughter outlined a range of threats, including faulty conclusions, failure to test, and proxy discrimination.[165]

162. Commissioner Slaughter outlined several actions the FTC could take.

> For example, we could use our deception authority in connection with algorithmic harms where the marketers of algorithm-based products or services represent that they can use the technology in unsubstantiated ways, such as to identify or predict which candidates will be successful or will outperform other candidates. Deception enforcement is well-trod ground for the FTC; ***anytime a company makes claims about the quality of its products or services***, whether or not those products are algorithm-based, ***the law requires such statements to be supported b*y ***verifiable substantiation***.[166]

163. Commissioner Slaughter also expressed support for the Algorithmic Accountability Act,[167] which would impose several new requirements on companies using automated decision-making, mandating that they:

- assess their use of automated decision systems, including training data, for impacts on accuracy, fairness, bias, discrimination, privacy and security;
- evaluate how their information systems protect the privacy and security of consumers' personal information; and
- correct any issues they discover during the impact assessments.

164. These statements from the FTC[168] and Commissioner Slaughter[169] routinely emphasize several themes:

a. Companies may not misrepresent AI products.

---

[165] Remarks of Commissioner Rebecca Kelly Slaughter Algorithms and Economic Justice, UCLA School of Law, Jan. 24, 2020, https://www.ftc.gov/system/files/documents/public_statements/1564883/remarks_of_commissioner_rebecca_kelly_slaughter_on_algorithmic_and_economic_justice_01-24-2020.pdf

[166] Id. (emphasis added)

[167] Algorithmic Accountability Act, H.R. 2231, S. 1108, 116th Cong. (2019).

[168] 2016 FTC Report, 2020 FTC Statement, 2021 FTC Statement, 2022 FTC Statement, 2023 FTC Statement.

[169] Commissioner Slaughter, *Algorithms and Economic Justice* (2020).

b. Companies must present the full scope of AI risk.

c. Companies must prevent discriminatory practices.

d. Companies must explain the basis of AI decisions to consumers.

e. Companies must ensure that decisions are fair.

f. Companies must ensure that models are empirically sound.

165. The FTC Statements on AI have also emphasized the agency's authority to act and desire to act. As the FTC recently explained, false or substantiated claims are the agency's "bread and butter."[170]

IX. Opportunity to Amend Complaint

166. CAIDP reserves the right to amend this complaint as other information, relevant to this matter, becomes available.[171]

X. Prayer for Investigation and Relief

167. CAIDP urges the Commission to Initiate an investigation into OpenAI and find that the commercial release of GPT-4 violates Section 5 of the FTC Act, the FTC's well-established guidance to businesses on the use and advertising of AI products, as well as the emerging norms for the governance of AI that the United States government has formally endorsed and the Universal Guidelines for AI that leading experts and scientific societies have recommended.

168. CAIPD further urges the Commission to

a) Halt further commercial deployment of GPT by OpenAI;

[170] FTC, *Keep your AI claims in check* (February 2023), https://www.ftc.gov/business-guidance/blog/2023/02/keep-your-ai-claims-check

[171] The public is invited to send suggestions for points to raise in a supplemental complaint to rotenberg@caidp.org.

b) Require the establishment of independent assessment of GPT products prior to future deployment;

c) Require compliance with FTC AI Guidance prior to further deployment of GPT

d) Require independent assessment throughout the GPT AI lifecycle;

e) Establish a publicly accessible incident reporting mechanism for GPT-4 similar to the FTC's mechanisms to report consumer fraud;

f) Initiate a rulemaking to establish baseline standards for products in the Generative AI market sector; and,

g) Provide such other relief as the Commission finds necessary and appropriate.

Respectfully submitted,

Marc Rotenberg, CAIDP General Counsel
D.C. Bar # 422825
rotenberg@caidp.org

Merve Hickok, CAIDP Research Director
hickok@caidp.org

Nidhi Sinha
CAIDP Research Fellow

Dr. Grace S. Thomson
CAIDP Research Fellow

Isabela Parisio
CAIDP Research Assistant

Christabel Randolph
CAIDP Research Assistant

Washington, DC
March 30, 2023

Center for AI and Digital Policy

April 3, 2023

Chair Lina M. Khan (@linaKhanFTC)
Commissioner Rebecca Kelly Slaughter (@RKSlaughterFTC)
Commissioner Christine S. Wilson (@CSWilsonFTC)
Commissioner Alvaro Bedoya (@BedoyaFTC)

Dear Chair Kahn, Commissioner Slaughter, Commissioner Wilson, and Commissioner Bedoya.

Enclosed is a formal complaint to the Federal Trade Commission. We urge the Commission to open an investigation into OpenAI and the commercial product GPT-4. We ask the Commission to halt further commercial deployment of GPT by OpenAI, pending the establishment of necessary safeguards.

We urge you to read our Complaint carefully. We also urge you to read the System Card and the Technical Report, provided by OpenAI, accompanying the release of GPT-4. The company itself has said that its product will be used for "Disinformation and influence operations," the "Proliferation of conventional and unconventional weapons," and "Cybersecurity attacks." OpenAI has also warned that "AI systems will have even greater potential to reinforce entire ideologies, worldviews, truths and untruths, and to cement them or lock them in, foreclosing future contestation, reflection, and improvement."

The FTC has previously declared that the use of AI should be "transparent, explainable, fair, and empirically sound while fostering accountability." GPT-4 satisfied none of these requirements. You have also said, "Merely warning your customers about misuse or telling them to make disclosures is hardly sufficient to deter bad actors." OpenAI intends to disclaim liability for the consequences of the commercial release of its product GPT-4.

Alarm bells should be ringing.

Thank you for your prompt consideration of this matter.

Sincerely yours,

Marc Rotenberg
CAIDP President
CAIDP General Counsel

Merve Hickok
CAIDP Chair
CAIDP Research Chair

Cc: Senator Maria Cantwelll, Chair, Senate Commerce Committee (@SenatorCantwell)
Senator Ted Cruz, Ranking Member, Senate Commerce Committee (@tedcruz)
Rep. Cathy McMorris Rodgers, Chair, House Commerce Committee (@CathyMcMorris)
Rep. Frank Pallone, Ranking Member, House Commerce Committee (@FrankPallone)

The New York Times

OPINION
LETTERS

Regulating A.I.: The U.S. Needs to Act

Representative Ted Lieu met in January with the head of OpenAI, the lab that developed ChatGPT.
Alyssa Schukar for The New York Times

To the Editor:

Re "A.I. Regulation Can Be Puzzle to Lawmakers" (front page, March 4):

The recent coverage of Washington's response to artificial intelligence is a welcome shift toward an overdue policy debate. But the challenge ahead is not so much about educating lawmakers about new technology — technologies are always changing — as it is about establishing the necessary safeguards to protect the public.

At the Center for A.I. and Digital Policy, we have closely examined A.I. policies and practices around the world. Europe has taken the lead with the proposed European Union A.I. act. The Council of Europe is drafting the first global convention on A.I.

UNESCO, with widespread global support, is beginning the implementation of the Recommendation on the Ethics of Artificial Intelligence. China is moving forward with both an aggressive research agenda and a comprehensive regulatory strategy. Most countries have established national A.I. strategies.

In contrast, the absence of a coherent national policy for A.I. in the United States is striking. While President Biden has taken several steps to promote cooperation among democratic nations on A.I. policy and establish rules to govern A.I., Congress appears to be taking a wait-and-see attitude, holding closed-door meetings without public hearings that could explore the challenges ahead.

This strategy poses a real risk to principles of fairness and accountability, public safety and national security. Lawmakers need to act now to protect the public from the dangers of unregulated A.I.

We need to prioritize laws that promote algorithmic transparency and limit algorithmic bias. We need to ensure fairness, accountability and traceability across the A.I. life cycle. With A.I.'s ability to amplify risk to a catastrophic scale, waiting until harms emerge may be too late.

Marc Rotenberg
Merve Hickok
Washington
Mr. Rotenberg is president and founder of the Center for A.I. and Digital Policy, a global research organization. Ms. Hickok is the chair and research director of the center.

KEVIN CRAMER
NORTH DAKOTA

SUITE 313
HART BUILDING
WASHINGTON, DC 20510
202-224-2043

United States Senate

April 13, 2023

Mr. Kenichiro Yoshida
Chairman, President, and Chief Executive Officer
1-7-1 Konan
Minato-ku, Tokyo, 108-0075 Japan

Dear Mr. Yoshida,

I write to express concern about Sony's efforts to protect its gaming console business from competition. For more than 20 years, Sony has utterly dominated the gaming console market, as that market has been defined by the Federal Trade Commission.[1] I am concerned Sony's dominance of that market, and its efforts to perpetuate its current position imperils an important economic development opportunity for North Dakota Therefore, I write to request more information about Sony's anticompetitive business practices.

As you know, gaming is a large and rapidly growing economic sector. A recent Accenture study estimated the gaming industry generated revenues of over $200 billion in 2021, and it remains on track to grow by over 20 percent on an annualized basis.[2] To prepare North Dakotans for careers in this burgeoning industry and other technology fields, North Dakota has developed a strategy to lead the nation in computer science and cybersecurity education to organically grow the next generation of technology professionals.[3] Preparing students for careers in gaming is an important component of this effort. This includes the 14 North Dakota high schools and universities participating in the competitive eSports revolution by instituting competitive gaming programs.[4] Last year, the University of North Dakota became one of the first U.S. higher education institutions to offer a Bachelor of Science degree in eSports, providing students with a career path to the video gaming industry.[5]

These investments are already showing their worth. Video gaming in the state produces an economic impact of more than $20.6 million statewide and accounts for an estimated 221 jobs, according to the Entertainment Software Association.[6] As gaming increasingly moves to mobile platforms, those numbers are set to grow dramatically. North Dakota projects approximately a 14 percent increase in technology job openings over the next 10 years and estimates 6,320 new and

---

[1] Microsoft/Activision: Administrative Part 3 Complaint (Public) (ftc.gov)
[2] https://www.accenture.com/us-en/insights/software-platforms/gaming-the-next-super-platform
[3] https://www.ndit.nd.gov/pk-20w-initiative-computer-science-and-cyber-education
[4] https://www.kxnet.com/video/video-games-as-a-sport-nd-high-schools-embrace-the-trend-of-esports/; https://www.kfyrtv.com/content/news/14-North-Dakota-high-schools-to-create-an-esports-league-512518802.html https://www.washingtontimes.com/news/2019/jul/8/14-north-dakota-high-schools-to-create-an-esports-/
[5] https://und.edu/programs/esports-bs/index.html
[6] https://www.theesa.com/video-game-impact-map/state/north-dakota/

replacement technology jobs will be needed in North Dakota over the next decade to support the growing tech industry.[7]

Given the growing significance of the gaming industry to North Dakota, I am troubled by reports Sony appears to leverage its dominance to exclude competition rather than enabling choice for players and developers.[8] According to published reports, Sony controls over 68%[9] of the global market for gaming consoles and a shocking 98% of the Japanese market.[10] Increasingly, it appears Sony's dominance is attributable to exclusionary practices, including paying game publishers not to distribute their games on rival platforms.[11]

Sony's anticompetitive conduct has also included lobbying the FTC and competition regulators abroad to oppose Microsoft's proposed acquisition of Activision,[12] a transaction many legal and gaming industry experts believe would promote a more competitive gaming market.[13] Even more troubling is the fact Sony's lobbying of the FTC and other regulators began shortly after Sony itself acquired Bungie, another major gaming competitor.[14] Sony's efforts to block this transaction apparently include a refusal to accept an agreement that fully addresses its concerns and would expand consumers' access to games.[15]

Sony's conduct hurts American consumers by leading to higher prices and reduced choice. Importantly, it also constrains economic opportunities for developers, including for small and independent developers.

To assure transparency regarding how Sony conducts its business, I ask you please provide unredacted copies of the following information:

1. All agreements that provide Sony with an exclusive right to distribute a game developed by an independent publisher;
2. All agreements between Sony and a game publisher that prevent the publisher from distributing its games on a rival's subscription or streaming service;
3. All internal company documents describing the strategic rationale for Sony's acquisition of Bungie, Inc.; and

---

[7] https://technd.org/Statistics

[8] https://www.theverge.com/2023/3/3/23623363/microsoft-sony-ftc-activision-blocking-rights-exclusivity

[9] https://www.polygon.com/23546288/microsoft-activision-blizzard-acquisition-deal-merger-ftc-latest-news

[10] https://subscriber.politicopro.com/article/2023/03/cantwell-calls-out-sonys-gaming-monopoly-in-exchange-with-us-trade-rep-tai-00088607

[11] https://gamerant.com/sony-xbox-game-pass-competitor-game-restriction-publishing-marketing-agreement-rumor/

[12] https://www.theverge.com/2023/3/8/23630700/sony-microsoft-call-of-duty-sabotage-cma-documents-activision-deal

[13] What's Past Is Prologue: Microsoft's Acquisition of Activision Blizzard Does Not Raise Foreclosure Concerns, Julie Carlson, Information Technology and Innovation Foundation; Bigger Means Different: Four Pro-competitive Arguments in Favor of Microsoft Buying Activision Blizzard, Joost van Dreunen, NYU Stern School of Business; Would Microsoft's Proposed Activision Merger Be Positive for Consumers?, Nate Scherer, American Consumer Institute.

[14] https://www.theverge.com/2022/7/15/23220335/bungie-sony-acquisition-complete-official-done

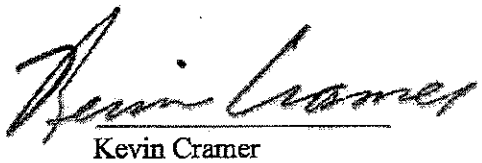
[15] https://twitter.com/lulumeservey/status/1633573596911075329?cxt=HHwWgoC85YCiz6stAAAA

4. All correspondence with any U.S. federal or state government or regulatory agency relating to competition in the video gaming industry.

Please respond in writing along with the requested information no later than May 1, 2023.

Thank you for your prompt attention to this important matter.

Sincerely,



Kevin Cramer
United States Senator

Cc: Gina M. Raimondo, Secretary of Commerce
Ambassador Katherine Tai, United States Trade Representative
Lael Brainard, Director, National Economic Council
Jeffrey Zients, Chief of Staff, White House
Bruce Reed, Deputy Chief of Staff, White House
Steve Ricchetti, Counselor to the President
Ambassador Susan Rice, Assistant to the President for Domestic Policy
Jonathan Kanter, Assistant Attorney General, U.S. Department of Justice
Lina Khan, Chair, Federal Trade Commission
Rebecca Kelly Slaughter, Commissioner, Federal Trade Commission
Alvaro Bedoya, Commissioner, Federal Trade Commission