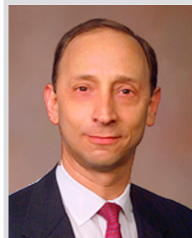
Economists Incorporated
Economists INK
SPRING 2017
A BRIEF ANALYSIS OF POLICY AND LITIGATION

Goldman Sachs Settles Allegations of Derivatives Benchmark Rate Manipulation

Stuart D. Gurrea and Jonathan A. Neuberger

EI Senior Economist Stuart D. Gurrea has extensive experience in constructing and assessing economic models. His consulting experience includes the calculation of damages and performing financial analysis.



EI Principal Jonathan A. Neuberger specializes in financial economics, valuation, and damages analysis in complex commercial litigation assignments across a broad range of industries. He also has extensive experience in constructing and assessing economic models.

Goldman Sachs (GS) recently agreed to pay a $120 million penalty to settle allegations by the U.S. Commodity Futures Trading Commission (CFTC) that GS's traders worked to manipulate benchmark rates used in derivatives markets. Specifically, the CFTC alleged that GS manipulated the U.S. Dollar International Swaps and Derivatives Association Fix ("ISDAfix"), a benchmark rate used to value a broad range of financial derivatives, including cash settlement options and interest rate swaps.

Similar to other benchmark rates, such as the London Interbank Offered Rate (LIBOR) and foreign exchange (FX) rates, the ISDAfix is determined based on inputs from market participants. ISDAfix submissions should reflect market-based actual rates offered in inter-dealer trades and executable inter-dealer bids at 11:00 am eastern time. A panel of banks, including GS, could then accept the market rate, submit a different rate, or take no action. (Since the time of the events in the CFTC complaint, the ISDAfix has been restructured and renamed the Intercontinental Exchange (ICE) Swap Rate.)

Allegations in other cases of manipulation of benchmark rates typically concerned concerted or coordinated efforts by a group of traders at multiple banks to manipulate the benchmark. The allegations settled here relate to GS traders' unilateral efforts to influence the fix in two ways. First, GS allegedly timed bids, offers, and execution of contracts to move the ISDAfix in a way that favored its trading positions. Second, GS allegedly made false ISDAfix submissions that were not driven by its true willingness to bid or offer swaps, but instead by GS's incentives in relation to its derivative positions. The misleading information allegedly was designed to benefit GS given its derivative positions priced in reference to the dollar ISDAfix. As a result, GS's submissions were purportedly higher or lower depending on the bank's then-current trading positions.

The conduct at issue in this case highlights the degree to which benchmark market rates are susceptible to manipulation. First, it shows rate-setting mechanisms that by design depend on the cooperative effort of multiple market participants still can be manipulated by individual participants. Second, it highlights the weakness of rate-setting mechanisms that are based on voluntary quotations by certain financial institutions rather than solely on transactional data. When relieved of the burden to tie their rate-setting submissions to actual transactions, participant banks can (and in some cases do) submit false or misleading information pertaining to hypothetical purchase and sell transactions affecting benchmark swaps.

Also In This Issue

FTC Again Looks at Merger Remedies

Robert D. Stoner examines the recently released Federal Trade Commission (FTC) study on merger remedies. The study, which systematically evaluated all 89 merger orders entered from 2006 to 2012, updated a previous merger remedy study completed in 1999. The 1999 study resulted in several changes to FTC merger remedy policies. The recent study attempted to determine how well those policy changes worked. The results indicated that divestitures of ongoing businesses generally succeeded, but divestitures of more limited packages of assets were less likely to succeed. Based on these findings, the Commission instituted a number of best practices recommendations. Although these do not reflect major changes to the Commission's current policies, they will have important implications for some merging parties. For example, FTC staff will likely increase its scrutiny of proposed divestitures that do not involve stand-alone businesses.

FTC Issues Report on Sharing Economy

Erica E. Greulich discusses a recent FTC report on peer-based platforms, such as Uber and Airbnb. Recent technological advances have allowed the rapid and widespread adoption of these platforms, which facilitate commercial transactions by creating marketplaces that allow individuals to buy and sell services. The platforms provide a search engine for customers and a method to efficiently match buyers and sellers. The report discusses numerous issues related to regulation of peer-based platforms, including whether and how regulation of these new business models should differ from existing regulation, the extent and possible role of peer-based platforms' self-regulation mechanisms, data privacy concerns, and the costs and benefits of providing platform-based data to governments.

FTC Again Looks at Merger Remedies

Robert D. Stoner

The Federal Trade Commission (FTC) recently released "The FTC's Merger Remedies 2006-2012." The study, which evaluated systematically all 89 merger orders entered during that period, updated a previous merger remedy study completed in 1999. The report led the Commission to institute best practice recommendations that may have important implications for some future merger remedies.

Almost all the 89 merger orders reviewed involved some divestiture of assets. The Commission generally prefers structural remedies, such as divestitures, to prevent competitive harm. Many mergers that raise competitive concerns do so in only a subset of the markets where the merging parties operate, so many times limited divestitures are sufficient to protect competition while allowing the merger to proceed. While some of these divestitures involved ongoing businesses, others involved only limited packages of assets. The report analyzed both types of divestiture.

The report gave greater scrutiny to remedies in certain industries, for which it used additional information in its analysis. It also used a different standard for judging if a divestiture succeeded in different industries. The goal of a merger remedy is often described as maintaining or quickly restoring the competitive situation that existed before the merger, i.e., to restore the pre-merger world. Ideally, a remedy would seek to achieve what would have been the going-forward competitive situation without the merger, i.e., the world but-for the merger, which may be different than the pre-merger world. However, in this study, success was often evaluated using the pre-merger standard.

> "[T]he FTC staff will likely increase its scrutiny of proposed divestitures that do not involve stand-alone businesses."

For 50 Commission orders in a broad range of industries, the report simply consisted of a case study. In those case studies, the FTC evaluated remedy success relative to a pre-merger world standard. This approach is understandable, due to the difficulty of constructing the but-for world, particularly given the number of cases that were analyzed. The case studies assumed that the pre-merger world is the but-for world, and analyzed the extent to which the competitive parameters that were identified in the original investigation of the merger still existed post-remedy. Using that standard to evaluate remedy success, the FTC case studies found that all of the divestitures involving ongoing businesses succeeded. By contrast, only about 70% of divestitures involving limited packages of assets succeeded.

A more detailed analysis was done of 15 orders in five industries: supermarkets, drug stores, funeral homes, dialysis clinics, and other health care facilities. That analysis included sending detailed questionnaires to buyers of the divested assets. With respect to these 15 divestitures, the standard of success was whether the divested assets were still operating in the relevant markets, i.e., whether the buyers that acquired the product lines at the time of the divestiture continued to sell them. These 15 orders involved divestitures to 43 buyers, and 39 of those divested businesses remained in the market. Thus, these divestitures were considered largely successful.

EI Principal Robert D. Stoner was previously a manager in the FTC's Bureau of Economics and has provided expert assistance in a number of merger matters since joining Economists Incorporated.

The most detailed analysis was of orders involving the pharmaceutical industry, which accounted for 24 of the 89 orders. Those orders were evaluated using Commission experience in this industry and reports from Commission-appointed "monitors." The standard of success for divestitures involving products in production at the time of the divestiture was whether divestiture buyers continued to sell them. With respect to divestitures involving products that were only in development at the time of the divestiture, the standard was simply whether these assets were successfully transferred to the approved buyers—a narrow definition of "success." The majority of the buyers that acquired products being sold at the time of the pharmaceutical divestitures still continued to sell those products, and all of the pharmaceutical products that were in the development stage at the time of the divestiture were successfully transferred.

The findings of the present study need to be understood in the context of the FTC's 1999 divestiture study. That study, which evaluated 35 horizontal merger orders entered from 1990 to 1994, resulted in several changes to FTC merger remedy policies. Most important among those changes was that, for divestitures of less than an ongoing business, or assets that raised risks of deterioration if divestiture was not accomplished quickly, the Commission began to require that buyers be identified before it issued the divestiture order. When post-order buyers (approved by the Commission

continued on page 4

FTC Issues Report On Sharing Economy

Erica E. Greulich

Recent technological advances have allowed the rapid and widespread adoption of platforms that facilitate commercial transactions among decentralized "peers." Platforms like Uber, Lyft and Airbnb have existed for fewer than 10 years, yet by 2015 15% of American adults had used an online ride-hailing "app" and 11% had used an online home sharing service. Uber reported that it was providing more than one million rides per day by the end of 2014, and Airbnb reported a cumulative total of over 60 million guests renting its listings by the end of 2015. The emergence of these Internet-based "sharing economy" business models has increased interest in the economic and regulatory issues presented by peer-based platforms. The Federal Trade Commission (FTC) recently released a staff report, "The 'Sharing' Economy: Issues Facing Platforms, Participants and Regulators," examining these issues.

Peer-based platforms create marketplaces that allow individuals to buy and sell services. The platforms, which are typically accessed through an Internet-capable device, provide a method to efficiently match buyers and sellers. Individual suppliers on these platforms frequently use their personal assets, for example a car or residence, to provide services. This practice greatly reduces suppliers' fixed costs and facilitates entry into markets, such as for-hire transport and short-term lodging. Peer-based platform suppliers' costs of entry and operation may frequently be lower than those faced by traditional incumbents, like taxicabs and bed and breakfasts, with which they compete to some degree. This disparity can be due both to peer-based platform suppliers' lower fixed costs and their ability to avoid some of the regulatory requirements imposed on traditional incumbents.

> "The type and extent of regulation imposed on peer-based platforms can affect entry, innovation, and suppliers' competitive advantage."

The FTC report discusses numerous issues related to regulation of peer-based platforms, including whether and how regulation of these new business models should differ from existing regulation, the extent and possible role of peer-based platforms' self-regulation mechanisms, data privacy concerns, and the costs and benefits of providing platform-based data to governments.

The type and extent of regulation imposed on peer-based platforms can affect entry, innovation, and suppliers' competitive advantage in the markets where those platforms operate. Overly burdensome regulation could restrict peer-based platforms' entry and innovation, thus reducing competition and the benefits of innovation conferred upon consumers. Conversely, failing to apply existing regulations to peer-based platforms and suppliers—particularly if they supply the same services as traditional incumbents—could undermine the existing regulations and their goals, or give one group of suppliers a competitive advantage that it did not gain from superior skill, business insight, or forethought. For example, cab companies have criticized Uber and Lyft, arguing that drivers using these platforms have an unfair advantage because they can avoid regulations imposed on cab drivers.

Erica E. Greulich is an empirical microeconomist who specializes in assessing liability and damages in antitrust, employment, and class action matters.

To the extent, however, that peer-based platforms do not provide the same services, provide them differently, or do not present the same safety risks as traditional suppliers, there may be reasons for differential regulatory treatment. The FTC has suggested in advocacy letters that policymakers should design regulations of peer-based platforms that are no more restrictive than necessary to solve a particular problem. Some observers, noting the rapidly evolving and "disruptive" nature of peer-based platforms, call for a flexible approach that would allow regulations to adapt to new and currently unforeseen situations.

Platforms, like eBay, Uber, and Airbnb, have developed reputation rating systems where service providers and consumers rate each other at the end of a transaction. Some suggest that peer-based platforms' self-regulation, which primarily includes such ratings systems, can substitute for government regulation. For example, self-regulating through ratings systems can improve the sanitation, cleanliness, safety, or other qualities of the services being provided. Airbnb's practice of fostering communication between hosts and renters prior to the rental transaction can reduce fraud. Evidence suggests that reputation mechanisms, although imperfect, benefit consumers by reducing asymmetries in information (when the seller knows more about the product or service being provided than does the purchaser). Nevertheless, peer-based platforms' self-regulation and ratings systems may not be well suited to address certain types of market failures, par-

continued on page 4

after the issuance of a divestiture order) were allowed, the default divestiture period was shortened from a year to six months. The Commission also increased its use of monitors. The present divestiture study attempted to determine how well those policy changes worked.

Based on the findings of the present study (and particularly the finding that divestitures of limited packages of assets sometimes did not succeed even when the buyer was identified upfront), the Commission instituted a number of best practices recommendations. Although these do not reflect major changes to the Commission's current practices, they appear likely to have important implications for some merging parties. First, because the study confirms the Commission's preference for divestitures of stand-alone ongoing businesses, rather than selected assets, the FTC staff will likely increase its scrutiny of proposed divestitures that do not involve stand-alone businesses. Second, to assure full analysis of potential buyers, the FTC expressed a preference that the parties proposing a divestiture remedy identify at least three potential "interested and approvable" divestiture buyers. Third, given the importance of attracting and retaining customers and the fact that the buyer does not always have an ongoing relationship with customers of the divested business, the FTC will increase its focus on facilitating the transition through such means as providing the divestiture buyer early access to customers, e.g., by assigning customer contracts. Fourth, the FTC likely will place increased emphasis on transition service agreements, like access to back-office functions and supply support, since the study found some buyers experienced unforeseen complexities in transferring critical back-office functions related to the divested assets. These agreements could involve longer entanglement between the divestiture buyer and seller, which the FTC has traditionally tried to minimize because of potential anticompetitive effects. Finally, for pharmaceutical transactions in particular, the FTC is likely to insist on divestiture of the product that can be more easily transferred to the buyer (e.g., because there is contract manufacturing). In the past, parties often had a choice of which products to divest.

Although the Merger Remedies study technically only applies to the FTC, the resulting changes in policy are not likely to be limited to that agency. The Antitrust Division of the Department of Justice has increasingly been applying similar standards to its remedies.

ticularly costs like traffic congestion or renters' excessive noise that are largely imposed on third parties.

Peer-based platforms' rating systems allow users to have some measure of trust in the individual on the other side of their transaction. That trust may be strengthened when the rating systems are combined with additional platform functions, including guarantees, background checks, and dispute resolution mechanisms. By allowing users to rate and review the quality of the goods and services offered on the platform, as well as participants' performance, buyers and sellers build reputations that can influence users' future purchasing behavior. Besides reducing asymmetric information, reputation rating systems may help identify particularly bad participants, like the Uber driver who may get lost or the Airbnb renter who may trash an apartment.

Platforms collect and maintain large amounts of data relating to users and transactions, including personal and payment information, locations, reviews and ratings, and customer preferences. The platforms' success and efficient operation frequently rely on this copious information, which makes trust mechanisms between buyers and sellers effective. However, such large amounts of personal data naturally give rise to concerns about privacy and data security, which must be balanced against benefits to the platform and its users. The FTC report suggests that platforms' clear delineation of what information will and will not be private can help consumers make informed decisions and mitigate privacy concerns.

The FTC report also discusses requiring platforms to share data with local governments to help design effective regulations. For example, one criticism of platforms such as Uber, Lyft and Airbnb is that many service providers are not just people making their car or home available when they are not using it, but rather individuals or other entities whose extensive activity on these platforms strongly resembles traditional commercial activity. For example, some users of Airbnb apparently make multiple properties and entire units generally available on the platform, suggesting that they may not be renting out their primary residences. Data sharing could illuminate the extent to which suppliers on these platforms appear to treat their involvement as a primarily personal or commercial endeavor, whether there may be reasons to regulate suppliers differently based on the extent to which they provide service, and whether there may be reasons to regulate peer-based platform suppliers differently from traditional suppliers in these markets. Should more data become available to governments and to the public, economic analysis can help determine answers to some of the questions that may influence future regulations in the markets where peer-based platforms operate.

EI News and Notes

Report on the Video Game Industry

Stephen E. Siwek of EI recently wrote *Video Games in the 21st Century: The 2017 Report.* The report, which was done for the Entertainment Software Association, measured the economic contributions that the U.S. entertainment software industry has made to the U.S. economy. The report found that in 2016, video game software sales exceeded $24.5 billion. Direct employment in the industry exceeded 65,000 employees, and the total employment that depended on the industry was over 220,000 employees. From 2013 to 2015, the industry's value added grew by 3.7% per year after adjusting for inflation.

Study of the Eight Voices Rule

EI economists Hal J. Singer and Kevin W. Caves published a study of the Federal Communications Commission's Eight Voices Rule. The rule, which they discussed in an article in this newsletter's last issue, prohibits mergers between television stations in the same Designated Market Area (DMA) unless at least eight independent broadcast television stations would remain in the DMA post-merger. The study uses an econometric analysis to find that markets with fewer than eight stations do not have higher local advertising rates than markets with eight or more stations. It concludes that the Rule "imposes an economically arbitrary threshold, fails to advance the Commission's stated objective of promoting competition, and proscribes transactions that would likely be deemed procompetitive under conventional competition analysis."

Court Grants Class Certification

The District Court for the Northern District of California certified a plaintiffs' class of end purchasers of lidocaine patches. The case involved allegations that a reverse payment settlement in patent litigation raised prices for that product. EI economist Hal J. Singer testified on behalf of the end-purchaser plaintiffs. The judge found that Dr. Singer developed a plausible method to determine but-for prices based on common proof. The end-purchaser plaintiffs were represented by Heins, Mills, & Olson PLC; Cohen, Milstein, Sellers, & Tolls PLLC; and the Joseph Saveri Law Firm Inc.

Economists
INCORPORATED

OFFICES:

2121 K Street, NW
Suite 1100
Washington, DC 20037
phone: (202) 223-4700
fax: (202) 296-7138

101 Mission Street
Suite 1000
San Francisco, CA 94105
phone: (415) 975-5510
fax: (415) 281-9151

1276 Metropolitan Blvd.
Suite 303
Tallahassee, FL 32312
phone: (850) 558-6030

www.ei.com

President
Jonathan L. Walker

Editor
Henry B. McFarland

in association with
The Allen Consulting Group in Australia

The opinions expressed by the authors are theirs alone and do not necessarily reflect the opinions of Economists Incorporated, its other economists, or its management.