REGULATORY REFORM

Be A Shame If Anything Happened to Your Merger...

"Regulatory leveraging" can be a useful tool or it can be an abuse of power.

BY WILLIAM E. KOVACIC AND DAVID A. HYMAN

Leveraging—a firm's tying together two or more of its products in order to boost sales—can be risky business. Firms that use substantial market power in one product to distort competition for a second product are attractive targets for claims of illegal tying and/or monopolization.

But what if the actor leveraging its market power is a government agency? Leveraging allows regulators to use their gatekeeping authority to secure concessions that they might not be able to achieve otherwise—and to do so quickly and cheaply. Should we applaud regulators for using a strategy that we would condemn when private parties do the same thing?

What kind of gatekeeping power makes regulatory leveraging possible? The most obvious example is the authority to grant or withhold approvals over something the regulated entity needs to function, such as a license to operate in a given market (e.g., the right to operate a radio station, cable system, or ferry) or the right to sell a particular product (e.g., a branded drug). A less obvious example is regulatory approval of a proposed merger. A common element in all of these settings is that if the regulator can attach conditions to the exercise of its gatekeeping authority, it can leverage outcomes that it might not be able to impose directly or could only accomplish at a much higher cost.

A concrete example may help in understanding the basic dynamics. Assume an agency uses its regulatory authority over mergers to extract concessions from the regulated entity on privacy and data security requirements. Does that raise any red flags? Does your reaction differ if the agency is using its authority over mergers to secure concessions that it could not obtain, or could realize only with great difficulty, if it focused

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solely on data security? What if the agency is using its authority over mergers to obtain concessions on data security that would be unconstitutional if it sought to impose them directly? Does it make a difference if the agency has no regulatory authority over data security? What if the agency does not have regulatory authority over data security, but a different agency that does have that authority has asked the competition agency to seek the concessions at issue? What if the agency is using its leverage to extract campaign contributions for favored constituencies or support for the priorities of agency leadership or their congressional masters?

REGULATORY LEVERAGING IN FIVE EASY PIECES

Is regulatory leveraging a normal, legitimate, and perhaps inevitable feature of agency design? Or is it hostage-taking that forces regulated entities to pay a sizeable ransom to be left in peace? We present five brief case studies that give a sense of the circumstances in which regulators can engage in leveraging.

Leveraging across two antitrust domains / A regulator can leverage its power across distinct areas within a single policy domain. In 2012, the Federal Trade Commission resolved two matters involving the international engineering and electronics firm Robert Bosch GmbH. The first involved Bosch's proposed acquisition of SPX Service Solutions, which would have given Bosch a "virtual monopoly in the market for air-conditioning recycling, recovery, and recharge devices." That issue was resolved with Bosch's agreement to divest its automotive air-conditioner repair equipment business and make some licensing commitments.

The same FTC press release that announced the agency's approval of the Bosch–SPX merger also announced that the FTC and Bosch had resolved a separate dispute over whether SPX had harmed competition by reneging "on a commitment to license key, standard-essential patents on fair, reasonable,

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and non-discriminatory (FRAND) terms." Bosch agreed to abandon SPX's claims for injunctive relief in those other cases, thereby resolving an ancillary matter that preceded the proposed merger.

It is not clear from the FTC's press release how these two entirely distinct issues came to be settled simultaneously. Their appearance in the same press release certainly inclines us to believe that they were resolved as a package deal.

Is it possible that Bosch could have gotten the merger approved without conceding the dispute over SPX's alleged abuse of FRAND terms? Of course. But Bosch had a huge incentive to give in on the SPX matter in order to obtain speedy approval of the proposed merger. FTC personnel knew that and could push hard for an immediate and outright concession. Even if FTC personnel never raised the subject, Bosch personnel were certainly aware that SPX was dealing with the FTC over the FRAND dispute—and it was a no-brainer for them to offer an outright concession to secure approval of the merger.

Cross-domain leveraging by a multipurpose regulator / In the second scenario, a multipurpose agency leverages power across distinct policy domains within its portfolio of duties. In recent years, the use of data about consumer behavior has become a major policy concern. Some commentators have suggested that merger approval is a useful mechanism to force firms to strengthen their privacy protections. The FTC confronted this issue in two merger reviews involving Google: in 2007 when Google sought regulatory approval for its acquisition of DoubleClick, and in 2010 when the FTC reviewed Google's purchase of AdMob.

The FTC had legal authority to review Google's proposed acquisitions of DoubleClick and AdMob. It also had authority to investigate Google's data protection and privacy policies. Agency personnel disagreed on whether the merger review should be used as an excuse/pretext/justification to delve into Google's data protection and privacy policies. FTC personnel in the Bureau of Consumer Protection were keen to use the merger review process as a way of getting Google to adopt more privacy-protective practices. Conversely, FTC personnel in the Bureau of Competition were unenthusiastic about having the merger review process hijacked for a detour into consumer protection-land.

After some back and forth, FTC personnel decided not to use the merger review process to extract concessions from Google regarding its data protection and privacy policies. Indeed, the FTC's closing statement in DoubleClick explicitly disavowed such strategies, noting that "the sole purpose of federal antitrust review of mergers and acquisitions is to identify and remedy transactions that harm competition." But a more expansive conception of harm to competition would have allowed the FTC to leverage its merger review authority to achieve desired objectives across a broader swath of the regulatory space.

Leveraging across policy domains occupied by other regulators / In the third scenario, an agency leverages power to affect a policy domain it does not "own." In 2013, Ally Financial was seeking approval from the Federal Reserve and the Federal Deposit Insurance Corporation to convert from a bank holding company to a financial holding company. It was also being investigated by the Consumer Financial Protection Bureau, an independent bureau located within the Federal Reserve. Although the CFPB has no regulatory authority over auto dealers, it decided to investigate whether the loan portfolios of indirect auto lenders such as Ally indicated that auto dealers were offering less favorable terms to minority borrowers.

According to Ally's former CEO, the CFPB "threatened to derail [Ally's] efforts to obtain key regulatory approvals if it didn't agree to settle" by paying $100 million and begin offering below-market rates to minorities. He complained that the CFPB "absolutely knew they had tremendous leverage over us" and was trying to change the policies of an industry it did not have the authority to regulate. Internal CFPB memos confirm that agency personnel knew that Ally needed regulatory approval. The impending deadline to obtain that approval gave the CFPB a stronger hand than it would have had otherwise, notwithstanding significant weaknesses in the CFPB's case against Ally.

Unsurprisingly, Ally folded, even though it had a strong case on the merits. It is impossible to know how the counterfactual would have played out, but it seems extraordinarily unlikely the CFPB would have been able to extract $100 million and a change in Ally's business practices—let alone do so under the same time frame—except under conditions that gave the CFPB an extraordinary degree of regulatory leverage.

Leveraging with a "public interest" mandate / In a fourth scenario, an agency can use a public interest mandate to achieve commitments that are not authorized by more specific legal commands. Many statutes delegate expansive regulatory authority by requiring an agency to consider the "public interest" in making decisions. For example, in evaluating proposed mergers, the Federal Communications Commission is required to evaluate whether the transaction will serve "the public interest, convenience, and necessity."

Public interest standards are an open-ended invitation to engage in regulatory leveraging. In 2016, the FCC used the merger review process to strong-arm Charter Communications to adopt net neutrality standards that the FCC had been (to that date) unable to impose through direct regulation. Over the past decade, the FCC has used the same strategy to impose net neutrality constraints on multiple other companies, including AT&T, Verizon, BellSouth, and Comcast.

These tactics are not new. In the 1990s, the FCC used regulatory leverage to press Westinghouse into increasing the number of hours devoted to children's educational programming on CBS. In 1971, the FCC released a list of songs that the commission believed promoted the use of illicit drugs—including "Lucy in the

Sky with Diamonds" by the Beatles and "Truckin'" by the Grateful Dead. Some stations responded by discontinuing playing "Puff the Magic Dragon" by Peter, Paul, and Mary.

State and local regulators can play the same game. In 2016, the District of Columbia Public Service Commission conditioned its approval of the Exelon–Pepco merger on a host of ancillary provisions, including a commitment to relocate certain offices to D.C., the hiring of unionized workers, and at least $1.9 million in annual average charitable contributions to organizations located in D.C. or benefiting D.C. residents.

Everybody's doing it! / Regulatory leveraging is a global phenomenon. Germany provides a recent, high-profile example. In December 2017, Germany's competition agency announced that it had concluded that Facebook had abused its dominant position "by making the use of its social network conditional on its being allowed to limitlessly amass every kind of data generated by using third-party websites and merge it with the user's Facebook account." Obviously, this is a complaint about Facebook's privacy policies with regard to the collection and use of data. But strikingly, the German privacy regulators were nowhere to be found; the entire investigation was handled by the Bundeskartellamt, Germany's antitrust authority. To some extent, the reticence of the German privacy regulators may have reflected perceived weaknesses in the country's data protection remedies compared to the stronger sanctions available under Germany's antitrust laws. Had the European Union's new General Data Protection Regulation (GDPR) and its more powerful remedial scheme been in place two years ago, we presume that Germany's data protection authorities would have taken the lead in addressing Facebook's conduct.

Although the GDPR in one sense moots the dispute in question, the Bundeskartellamt's Facebook investigation is a striking example of how competition law can create regulatory leverage that can be used in non-antitrust domains. In fairness, the original announcement of the Facebook investigation in 2016 disavowed the use of competition law to treat "every law infringement ... [by] a dominant company." But we can readily imagine many instances in which a dominant firm's misconduct might distort consumer choice. In practice, that means the competition agency will become the backstop enforcer of a potentially large collection of non-competition-focused statutes and regulations.

The full implications of this approach were spelled out in an extraordinary proposal advanced by FTC Chairman Michael Pertschuk in 1977. He suggested that the commission could use its "unfair methods of competition" authority to challenge noncompliance with legal obligations governing environmental protection, immigration, and worker safety. The FTC never acted upon his theory, but a variation on the same theme seems to have been a factor in the German competition authority's action against Facebook.

BENEFITS AND COSTS OF REGULATORY LEVERAGING

The most obvious benefit of regulatory leveraging is that it promotes more comprehensive settlements. In Bosch–SPX, the FTC already had an open file on SPX, and Bosch then came to the FTC with the proposed merger. Isn't it more efficient to adopt one global settlement instead of maintaining two separate proceedings? If there are benefits in settlement (and there are), more comprehensive settlements must be better still.

Second, depending on the statutory language that is employed, leveraging may be an authorized delegation of legislative authority to regulate in a flexible way. Stated differently, Congress may have used "public interest" language to give the agency a hammer that could be deployed when a regulated entity comes to the agency for merger approval. But the agency can only use the hammer in carefully defined circumstances. This structure keeps the agency from expanding its regulatory leverage beyond any given transaction, while giving it the flexibility to solve problems without going through the drudgery of rule-making or starting a separate case. And if the agency goes too far, the courts and the legislature stand ready to protect the rule of law.

Regulatory leveraging also involves real risks and disadvantages. For starters, it leads to less disciplined decision making by governmental agencies. Agencies have an incentive to ignore or downgrade the controls imposed by the substantive regulatory regime and use leverage to circumvent those restrictions.

Second, regulatory leveraging leads to less transparent and less accountable decision making. Merger review rarely ends up in court, so agency leadership need only persuade itself that its "wish list" is worth pursuing. Firms badly want to obtain immediate approval of their mergers, so agencies have them over a barrel.

Third, regulatory leveraging can be used for "good" or "evil." Readers may like the results of regulatory leveraging when an agency is run by their friends and political allies, but will they be quite so enthusiastic if the same power is turned over to their adversaries? Stated more concretely, what if the FTC and DOJ agreed they would both demand the following as a condition of approving a merger involving the listed companies:

- Apple had to agree to unlock any iPhone provided to it by the Department of Homeland Security, the Central Intelligence Agency, the Federal Bureau of Investigation, the Drug Enforcement Administration, and the Bureau of Alcohol, Tobacco, Firearms and Explosives.
- Verizon had to agree to provide immediate and unrestricted access to the text messages associated with any subscriber's number, without requiring a warrant or notifying the subscriber, upon request by any federal, state, or local governmental entity.
- Google had to create a backdoor to Gmail and turn it over to the National Security Agency.

- Salesforce had to fire its chief executive officer, who was the ringleader of corporate attempts to pressure Republican state lawmakers on social issues. For every dollar Salesforce had to pay its CEO to go away, it had to pay 10 times that amount to support the Tea Party.
- PayPal had to reverse its decision to cancel a $3.6 million operations center in Charlotte, NC in response to the state's enactment of the "Public Facilities Privacy and Security Act." PayPal also had to spend at least twice that amount endowing a center at the University of North Carolina for the study of the War of Northern Aggression. Finally, each member of PayPal's board and senior management (including vegetarians, vegans, and those with religious objections to eating pork) had to spend a week eating only Carolina barbecue and drinking sweet tea, after which they had to personally hand-write a five-page essay on the virtues of that diet.
- All companies seeking merger approval had to make large contributions to foundations created and administered by the FTC and DOJ. The funds may be used for any purpose the FTC and DOJ deem appropriate.

As this list of horribles is intended to suggest, regulatory leveraging is not all upside. Indeed, there is significant risk of abuse.

Finally, because regulatory leveraging is firm-specific, it can create significant discontinuities in the applicable law. Only firms that have had a merger reviewed by the agency will be subject to regulatory leverage—and the details of the resulting settlements may well vary depending on the priorities of agency leadership at the time the merger was reviewed and the extent to which firm management was willing to give away the store to get the merger approved. These discontinuities make a mockery of the principle of equal justice under law and also create real frictions in the markets for corporate control.

SQUARING THE REGULATORY LEVERAGING CIRCLE

Some of the time, regulatory leveraging is a problem. And some of the time, regulatory leveraging is the only available solution. This is not the kind of scenario that lends itself to a simple fix. But following in the steps of the late James Q. Wilson, we propose "a few modest suggestions that may make a small difference."

- ***Clear grants of authority.*** If Congress wants agencies to engage in regulatory leveraging, it should explicitly authorize the process and identify some boundaries. Should agencies only engage in leveraging for substantive areas of law within their zone of regulatory authority or should they be allowed to range more widely? What criteria should an agency employ in deciding whether to engage in regulatory leveraging? An express congressional delegation of authority would go a long way toward legitimizing an agency's use of regulatory leveraging.
- ***More transparency.*** Agencies should be more explicit about what and how they leverage. This will simultaneously discipline their use of regulatory leveraging and force them to articulate and justify their conduct. If an agency believes that regulatory leveraging is a sensible way of solving a problem, it should forthrightly explain and justify its actions. If an agency isn't willing to brag about what it is doing, it probably shouldn't be doing it. If regulators can't stand the heat, they should get out of the kitchen.
- ***Fewer gates.*** More gates mean more gatekeepers and more opportunities for regulatory leveraging. The obvious solution is to be careful about creating new gates and revisit the necessity of existing gates. Before creating new gates, legislators should decide whether they are necessary—and if so, whether the responsible agency may engage in regulatory leveraging and under what circumstances the leveraging can occur. Legislators should also "sunset" all gates to force routine reconsideration of the need for each gate.
- ***Better norms.*** Regulatory leveraging is, at best, a third-best solution for dealing with policy problems. In some instances, internal agency dynamics will discourage the use of regulatory leveraging. But a robust government-wide norm against the use of regulatory leveraging could play a useful backup role.
- ***Ex-post review.*** We don't know how often regulatory leveraging takes place, the circumstances under which it occurs, and how effective (or ineffective) it actually is. But there have been complaints about the exercise of regulatory leverage by multiple entities within the federal government. At the state and local level, many "takings" cases involve similar instances of regulatory exactions, including the compelled surrender of land to create bicycle or pedestrian paths and cash settlements to be controlled and disbursed by the regulators. And there are the long-standing arguments over "unconstitutional conditions" and the spending power.

We don't know nearly enough about the prevalence and results of regulatory leverage. Only a consistent practice of ex-post review can cast light on these issues.

CONCLUSION

Extortion schemes typically involve some variation on the theme: "Nice place you got here. Be a shame if anything happened to it." It is understandable why those on the receiving end of regulatory leveraging perceive themselves to be in a similar "Your money or your life" bargaining position.

Regulators like leverage, and some of the time it is the only available solution to a particular problem. But regulatory leverage raises very real risks and costs. That counsels for considerably greater caution than regulatory agencies have shown to date. Stated bluntly, unless regulatory leveraging is properly disciplined, it invites lawlessness. R