Chapter 2
The Regulatory Environment

Answers to End of Chapter Discussion Questions

2.1 What factors do U.S. antitrust regulators consider before challenging a merger or acquisition?

Answer: Regulators attempt to measure the likelihood of increased market power, i.e., the ability to raise prices resulting from a business combination. Initially, regulators examine the size of the market and the increase in industry concentration that might ensue. Other factors that are considered include the potential for coordinated interaction among current competitors, the extent to which products are differentiated in the minds of consumers, and the similarity of substitute products. Frequently, M&As can be approved if it can be demonstrated that the combination of certain businesses will result in enhanced efficiency and eventually lower prices. Finally, regulators consider the likelihood that a firm would fail if it were not merged with a more viable business.

2.2 What are the obligations of the acquirer and target firms according to Section 14(d) of the Williams Act?

Answer: The acquirer must disclose its intentions and business plans as well as any agreements between the acquirer and the target firm in a Schedule 14D-1. The disclosure must also include the types of securities involved, the identities of the person, partnership, syndicate, or corporation that is filing, and any source of funds used to finance the tender offer. The target firm cannot advise its shareholders on how to respond to the tender offer until it has filed a Schedule 14D-9 with the SEC inside 10 days after the tender offer's commencement date.

2.3 Discuss the pros and cons of federal antitrust laws.

Answer: Such laws are intended to prevent individual corporations from assuming too much market power such they can limit their output and raise prices without concern for any significant competitive reaction. Antitrust laws such as the Hart-Scott-Rodino Act require that the firms involved in the pending transaction notify the regulatory authorities before completing the transaction. The regulators thus have time to assess the potential anticompetitive effects of the transaction before hand to avoid the disruption involved in dismembering the combination once it has been completed. Using consent decrees, regulators are able to reduce potential concentration by requiring the parties to the transaction to divest substantially overlapping portions of their businesses (so-called structural decrees) or to pursue policies minimizing anticompetitive practices (so-called behavioral decrees).

The ability of regulators to assess accurately potential anticompetitive effects is often questionable. Defining concentration is heavily dependent on their ability to define the market, ease of entry for new competitors, current competitors (including foreign), the availability of substitute products, and the extent to which products are differentiated. Inappropriate challenges to M&As may thwart potential improvements in efficiency and innovation. Antitrust policy sometimes ignores market dynamics such as the accelerating change in technology, which may result in the introduction of new substitute products, thereby undermining the dominant firm's competitive position.

2.4 When is a person or firm required to submit a Schedule 13D to the SEC? What is the purpose of such a filing?

Answer: Any person or firm acquiring 5% or more of the stock of a public corporation must file a Schedule 13D with the SEC within 10 days of reaching that percentage ownership threshold. The disclosure is necessary even if the accumulation is not followed by a tender offer. The filing is intended to give target shareholders access to sufficient information and an adequate amount of time to evaluate properly a tender offer.

2.5 Give examples of the types of actions that may be required by the parties to a proposed merger subject

to a FTC consent decree?

Answer: A typical consent decree requires the merging parties to divest overlapping businesses (structural decrees) or take actions (behavioral decrees) that minimize activities that are perceived by the regulators as anticompetitive.

2.6 Having received approval from the Justice Department and the Federal Trade Commission, Ameritech and SBC Communications received permission from the Federal Communications Commission to form the nation's largest local telephone company. The FCC gave its approval of the $74 billion transaction, subject to conditions requiring that the companies open their markets to rivals and enter new markets to compete with established local phone companies. SBC had considerable difficulty in complying with its agreement with the FCC. Between December 2000 and July 2001, SBC paid the U.S. government $38.5 million for failing to provide adequately rivals with access to its network. The government noted that SBC failed repeatedly to make available its network in a timely manner, to meet installation deadlines, and to notify competitors when their orders were filled. Comment on the fairness and effectiveness of using the imposition of heavy fines to promote government-imposed outcomes, rather than free market outcomes..

Answer: The use of fines to achieve social objectives assumes that the government can provide a better solution than the free market. In general, the imposed solution will be less efficient that what the free market would have determined. It requires the government to determine what constitutes a fair solution. Such definitions are often arbitrary, politically motivated, and result in less innovation and less product variety offered to customers and, in some cases, higher prices. The usual justification for the use of fines in a regulated industry is that industries such as utilities are "natural monopolies" not subject to competitive market conditions. While this may have been a compelling argument in the past, it is less relevant today due to the emergence of a variety of competing technologies such as voice over internet and wireless telephony.

2.7 In an effort to gain approval of their proposed merger from the FTC, top executives from Exxon Corporation and Mobil Corporation argued that they needed to merge because of the increasingly competitive world oil market. Falling oil prices during much of the late 1990s put a squeeze on oil industry profits. Moreover, giant state-owned oil companies are posing a competitive threat because of their access to huge amounts of capital. To offset these factors, Exxon and Mobil argued that they had to combine to achieve substantial cost savings. Why were the Exxon and Mobil executives emphasizing efficiencies as a justification for this merger?

Answer: Current antitrust guidelines recognize that the efficiencies associated with a business combination may offset the potential anti-competitive effects of increased concentration. The guidelines call for an examination of the net effects of the proposed combination. Proving that the presumed efficiencies justify the merger is difficult, since most synergies will not be realized for a number of years. It is therefore difficult to measure their true impact and often even more difficult to unravel the anticompetitive impacts that might ensue from the merger.

2.8 Assume that you are an antitrust regulator. How important is properly defining the market segment in which the acquirer and target companies compete in determining the potential increase in market power if the two firms are permitted to combine? Explain your answer.

Answer: Whether a company is able to engage in anticompetitive practices is heavily dependent on how the market is defined. The presumption is that the degree of pricing power is directly related to the degree of market concentration. If the market is defined narrowly, the Herfindahl index will show a much higher level of concentration than if the market is more broadly defined to include regional, national, or foreign sources of supply..

2.9 Comment on whether antitrust policy can be used as an effective means of encouraging innovation. Explain your answer.

Answer: Regulation almost always is reactive rather than proactive. Efforts to promote innovation through regulation may be particularly inappropriate in that the conditions that give rise to innovation are not well understood. For example, efforts to establish product standards may promote innovation by enabling software developers to focus on developing new products for the Windows standard. Without a standard, the risk of developing new applications is higher due to the potential for developing products for operating systems that achieve a relatively low market share in the future. However, the existence of standards may also make it possible for companies such as Microsoft to stifle innovation by embedding innovative ideas developed by others in their operating system as they have done in the past.

2.10 The Sarbanes-Oxley Act has been very controversial. Discuss the arguments for and against the Act. Which side do you find more convincing and why?

Answer: Detractors argue the Act is overkill in that it imposes costly and unnecessary burdens on firms. They argue that many firms have de-listed from the major exchanges in recent years because of these added reporting costs. There is evidence that the Act has been disproportionately burdensome on small firms. However, changes in the law may alleviate this problem. Proponents argue that, while hard to quantify, the Act has increased public confidence in the equity markets and at least reduced the perception of fraud. While some firms have de-listed, this does not mean that they will be able to avoid the reporting requirements of the Act if they issue high yield debt to finance their LBO. To the extent the Act promotes better governance, it is likely to be worth the additional expense. However, the inability of the Act to mitigate the collapse in U.S. financial markets in 2008 raises serious questions about its effectiveness in promoting greater financial transparency.

Solutions to Chapter Case Study Questions

Case Study 2.1 Global Financial Exchanges Pose Regulatory Challenges

Discussion Questions:

1. What are the key challenges facing regulators resulting from the merger of financial exchanges in different countries? How do you see these challenges being resolved?

   Answer: Despite the merger, the exchanges are still subject to local government securities' regulations when trading in a particular company's shares. The rules that apply depend on where the company is listed. For example, EU regulators will still have authority over Euronext and the SEC will continue to regulate the NYSE. Moreover, EU member states will continue to set their own rules for clearing and settlement of trades. Assuming the rules are compatible across countries, the process should be relatively transparent for individual trades. However, the various regulators will have to learn to closely coordinate their regulations if this is to happen. This coordination may take some time.

2. In what way are these regulatory issues similar or different from those confronting the SEC and state regulators and the European Union and individual country regulators?

   Answer: In the U.S., state securities' laws can be more onerous than federal laws. Moreover, they may differ from state to state. Consequently, an issuer seeking exemption from federal registration will not be exempt from all relevant registration requirements until a state-by-state exemption has been received from all states in which the issuer and offerees reside. State restrictions can be more onerous than federal ones. Compliance with all applicable regulations (including federal) can become a major challenge. The same logic applies to the relationship between the EU and its member countries.

3. Who should or could regulate global financial markets?

Answer: The potential for rivalry exists among regulatory bodies within a country. This potential often is compounded when markets cross national boundaries as nationalistic concerns emerge. In the abstract, it may seem that a global body needs to be formed to regulate such markets. However, the more likely case is that international protocols will be established among countries' regulatory bodies as the issues arise. If the perceived benefits of the merging of the exchanges are accepted by the various national regulatory agencies, accommodations will be made.

4. In your opinion, will the merging of financial exchanges increase or decrease international financial stability?

Answer: Disparate regulations and trading expenses inhibit the free flow of capital internationally. To the extent the merging of the exchanges harmonize applicable national regulations and reduce transactions costs, capital is likely to flow more easily across borders and contribute to the reduction in the cost of capital in developed countries for multinational firms. The easier flow of capital would pressure governments to better coordinate their monetary and fiscal policy, thereby contributing to global financial stability. Historically, developed countries have made great strides in coordinating monetary policies through the so-called "group of eight" country meetings.

Case Study 2.2 The Importance of Timing: Express Scripts Acquires Medco

Discussion Questions:

1. Why do you believe the U.S. antitrust regulators approved the merger despite the large increase in industry concentration?

Answer: While market concentration often is a necessary condition for firms to engage in monopolistic pricing practices, it is by no means sufficient. Highly concentrated industries such as autos, airlines, steel, and aluminum often are highly price competitive due to the commodity-like nature of their products and the comparatively low cost to customers of substituting one product for another. Furthermore, pharmacy benefit managers compete largely on price and service since what they offer their clients is largely a commodity. Even though the pharmacy benefit management market is highly concentrated with the top four competitors accounting for well-over one-half of the market, customers find it relatively easy to switch PBMs. This is evidenced by the ability and willingness of customers to move to more competitively priced plans. These low "switching costs" and the apparent absence of highly differentiated products make the PBM market highly competitive.

2. Did the timing of the proposed merger between Express Scripts and Medco help or hurt the firms in obtain regulatory approval? Be specific.

Answer: Escalating healthcare expenses represent in increasingly burdensome expense for both public (e.g., Medicare and Medicaid) and private insurers in the U.S. PBMs offer a potential solution to the perceived mismatch between the bargaining power of healthcare vendors (drug manufacturers) and providers (drug store chains) and their customers. In some countries, the government represents the sole buyer of medical services and products such as pharmaceuticals. In the U.S., PBMs potentially offer leverage in bargaining with manufacturers and drugstore chains and also the potential for greater operational efficiencies than what often is found in governmental agencies.

3. Speculate as to how the Express Scripts-Medco merger might influence the decisions of their competitors to merge? Be specific.

Answer: The approval of regulators of this transaction could serve as a "green light" for other PBMs to feel that they would also receive merger approval if they were to pursue this strategy. In addition, increasing scale may be a requirement for future success as a PBM. Scale is necessary to

achieve negotiating leverage with drug manufacturers, to provide customer support services, and to finance and operate geographically dispersed mail handling operations. Consequently, increased consolidation through M&A may be a natural result of this regulatory ruling.