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An Independent Study of Media Transparency in the U.S. Advertising Industry

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Prepared for:

The Association of National Advertisers

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1. Executive Summary

- From October 20, 2015 through May 31, 2016, K2 Intelligence, LLC (“K2”) conducted an independent study of media transparency issues in the U.S. advertising industry on behalf of the Association of National Advertisers (“ANA”). K2 was selected to lead the fact-finding portion of the study after a Request for Proposal process initiated by the ANA on June 17, 2015. Ebiquity/FirmDecisions (“Ebiquity”) was selected to partner with K2 for the purpose of developing practical recommendations to address the study’s results.
- Over the course of the study, K2 requested interviews with 281 sources and ultimately conducted 143 interviews with 150 individual sources, representing a cross-section of the U.S. media-buying ecosystem. K2 kept the identities of all participating sources – and all of the individuals and corporate entities named in their accounts – confidential from both Ebiquity and the ANA throughout the study. At all times, K2 maintained complete authority over the methodologies utilized by the study team, as well as full editorial control of this report.
- Within the sample studied by K2, non-transparent business practices were found to be pervasive. Of the 150 sources interviewed by K2, 117 were directly involved in media buying in the U.S. market. Of those 117 sources, 59 reported direct experience with non-transparent business practices, including rebates (34 sources) and principal transactions that enabled potentially problematic practices (33 sources). Some of these sources reported multiple experiences with separate and unrelated non-transparent business practices (e.g., the same source reporting both rebates and problematic principal transactions).¹
 - Non-transparent business practices were not limited to a specific type of agency. K2 found substantial evidence of non-transparent business practices in Agency Holding Companies, as well as in certain independent agencies. Evidence included both detailed source accounts and significant documentary evidence.
 - Non-transparent business practices were not limited to one specific type of media. K2 found evidence of non-transparent business practices across digital, OOH, print, and television media.²
 - There were systemic elements to some of the specific instances of non-transparent business practices examined by K2, in that these practices appeared to be part of the regular course of business. Specifically, K2 found evidence that senior executives at agencies and Agency Holding Companies were aware of and even mandated some non-transparent business practices, suggesting high-level buy-in. K2 also found evidence that contracts for rebates and other non-transparent business practices were negotiated and sometimes signed by agency executives.

¹ This overlap accounts for why the total of 59 sources who reported non-transparent business practices is less than the sum of those reporting rebates (34) and principal transactions that enable potentially problematic agency practices (33).

² Please note that the degree of participation in the study varied significantly between media types. For instance, K2 was able to interview numerous sources from digital and OOH, but very few from television and print and none from radio. As a result, the absence of examples of non-transparent business practices in media types for which K2 had few sources should not be taken as conclusive evidence that such practices do not exist within the larger media-buying ecosystem.

- The pervasiveness of these practices in the sample strongly suggests that non-transparent business practices are also common in the media-buying ecosystem from which the sample was drawn.
- K2 found substantial evidence of non-transparent business practices in the U.S. market in the form of rebates. K2 interviewed 41 sources who reported that media rebate deals occur in the U.S. market. Of those 41 sources, 34 reported indicia that the rebates were not disclosed to advertisers, were not passed through to advertisers, and/or were demanded by agencies. K2 also obtained corroborating documentary evidence of rebates, including email threads and contracts between media suppliers and media agencies. This collective body of evidence showed a range of instances in which media suppliers paid rebates to agencies, or entities affiliated with those agencies, in amounts ranging from 1.67% to approximately 20% of aggregate media spending, depending upon the deal. K2 identified several cases in which the percentage of the rebate owed increased along with agency spend.
- K2 identified evidence of several methods by which rebate deals are structured, including financial incentives in the form of cash or free media. Other sources noted that rebates are often structured as service agreements whereby the fees for the services – usually described as consulting or research – are tied to the volume of agency spend. Moreover, these services were either of minimal utility, significantly overpriced, or not provided at all.
- During the course of this study, K2 found substantial evidence that the lack of transparency inherent in principal transactions enables agencies to engage in potentially problematic conduct – i.e., conduct that may not be in the advertiser’s best interest. Many advertiser-agency contracts contain “opt-in” provisions that permit the agency to engage in certain principal transactions with advertisers. In a principal transaction, an Agency Holding Company essentially acts as a media supplier by purchasing media on its own behalf and then reselling it at a markup. When an agency within the Agency Holding Company sells the media to an advertiser, the original purchase price – as well as other potentially relevant information – is not disclosed. According to information provided to K2, markups on media sold through principal transactions can range from approximately 30% to 90%. Sources also indicated that media buyers are sometimes pressured and/or incentivized by their Agency Holding Companies to direct client spend to this media, regardless of whether such purchases are in the clients’ best interest.
- K2 found evidence of non-transparent business practices in the U.S. market arising from agencies holding equity stakes in media suppliers. Several former senior level agency employees reported that they felt pressure from the senior executive level of Agency Groups or Agency Holding Companies to direct spend to companies in which the agency or holding company held an equity investment.

- K2 found evidence of a fundamental disconnect in the advertising industry regarding the basic nature of the advertiser-agency relationship. In general, advertisers expressed a belief that their agencies were duty-bound to act in their best interest. They also believed that this obligation – essentially, in their view, a fiduciary duty – extends beyond the stated terms in their agency contracts. While some agency executives expressed similar beliefs, others told K2 that their relationship to advertisers was solely defined by the contract between the two parties. Some sources further noted that their obligations to their respective Agency Holding Companies were sometimes in conflict with the interests of their clients.

2. Introduction

2.1. Background and Purpose

On June 17, 2015, the Association of National Advertisers (“ANA”) issued a request for proposal (“RFP”) to conduct an independent fact-finding study to shed light on transparency issues within the advertising industry and then develop practical recommendations to address them. The ANA’s decision to issue the RFP was driven by two related factors: (1) the industry’s rising awareness and growing concern about media transparency issues; and (2) a “lack of a common perspective”³ regarding the nature of the actual business practices in use throughout the media-buying ecosystem. In the ANA’s estimation, this unique combination of factors – i.e., widespread concern about certain business practices plus a lack of consensus on whether those practices were actually occurring – was the root cause of a progressive and counter-productive erosion of trust among industry constituents. Accordingly, the ANA’s primary purpose in commissioning the study was to “demystify the landscape”⁴ through robust and independent fact-finding and thereby create a solid factual foundation upon which longstanding relationships of trust could be rebuilt.

On October 20, 2015, the ANA announced via a press release⁵ that it had selected K2 Intelligence, LLC (“K2”) and Ebiquty/FirmDecisions (“Ebiquty”) to lead the study. A brief background on K2 and the core team that conducted the study is provided below. In addition, the scope of the study – and the specific methodologies that K2 and Ebiquty employed in an effort to achieve the ANA’s stated goals – are outlined in the sections that follow.

2.1.1. Firm Background

K2 Intelligence is an investigative, compliance and cyber defense services firm founded in 2009 by Jeremy M. Kroll and Jules B. Kroll, the originator of the modern corporate investigations industry. With offices in New York, London, Madrid, Tel Aviv, Geneva, and Los Angeles, K2 provides specialized research, fact-finding, and compliance services to public and private corporations, boards of directors, non-profit organizations, individuals, and government clients across the globe. Common engagements include complex investigations of all varieties, pre-transactional due diligence, cyber investigations and defense, asset searches, and fact-finding in support of high stakes disputes and litigation. K2’s multi-disciplinary teams consist of a diverse collection of professionals, including former state and federal prosecutors, experienced researchers and analysts, financial and forensic investigators, former law enforcement officials and intelligence operatives, investigative journalists, and litigation and enforcement attorneys.

³ “Media Transparency RFP,” ANA, June 17, 2015. See: <http://www.ana.net/content/show/id/media-transparency-rfp>

⁴ *Ibid.*

⁵ “ANA selects K2 Intelligence and Ebiquty/FirmDecisions to lead Media Transparency Fact-Finding Effort”, ANA press release, October 20, 2015. See: <https://www.ana.net/content/show/id/36997>

The core K2 team for this study consisted of five professionals. The qualifications of each team member is described briefly below:

- An executive managing director with nearly 25 years of fact-finding experience, who formerly served as an Assistant District Attorney in New York County and the Deputy Criminal Justice Coordinator for the Mayor of the City of New York;
- A senior managing director with 15 years of fact-finding experience, who formerly served as an Assistant United States Attorney in the Southern District of New York and New York State Deputy Attorney General, Deputy Chief of Investigations, for the Moreland Commission to Investigate Public Corruption;
- A managing director with 15 years of fact-finding experience, who formerly served as an Assistant District Attorney in New York County and as Assistant Deputy Inspector General and Director of the Contract and Construction Fraud Unit for the New York State Office of the Inspector General;
- An associate managing director with a decade of investigative experience in the public and private sectors; and
- An analyst and former investigative news journalist with 15 years of experience in print and online platforms, and a co-author for an independent audit into the state of media freedom in Australia.

2.2. Study Scope

Throughout this study, K2's primary focus was to identify, illuminate, and document non-transparent business practices to the extent they exist in the media-buying space, specifically in the United States market. At the outset, it is important to be clear on exactly how K2 defined non-transparent business practices for purposes of this study.

2.2.1. Non-Transparent Business Practices Defined

Transparency is commonly defined, in a business context, as the full disclosure of relevant information required for informed and intelligent decision-making; as a corollary, it is also distinguished by the lack of hidden agendas and conditions. Accordingly, for purposes of this study and our findings, a non-transparent business practice is one in which relevant information is not disclosed or intentionally obscured from one party to a transaction.

In the specific context of media buying – and for purposes of this report – a non-transparent business practice is one in which an advertiser does not have full access to the information necessary to assess the value of a media purchase and the associated margin. Examples of such information could include:

- The existence of any incentives offered by media suppliers to agencies (e.g., discounts, rebates) to buy certain media (even if other media is comparable or costs less);
- If such incentives exist, whether and how such benefits are passed back to the advertiser;
- The existence of any internal incentives offered by an agency or Agency Holding Company to its own employees to encourage the purchase of certain media;

- The underlying cost of media and approximate agency margin;
- The existence and degree of any markup on non-media costs;
- The existence of commercial arrangements or partnerships with media suppliers that have the potential to influence media buying choices; and
- The quality of the media and all relevant information about the audience it is meant to target.

Please note that this list is intended to be illustrative and not comprehensive. In the context of a specific transaction, it is certainly possible that other types of information might be relevant and necessary for the making of an informed media-buying decision.

2.2.2. Qualifications

In addition to the definition above, this study's focus on non-transparent business practices requires two important qualifications.

First, K2's fact-finding revealed that some contracts between advertisers and their agencies permit agencies to engage in non-transparent business practices; clearly, transparency and contract compliance are not one and the same in the media-buying space. However, even if a particular non-transparent practice is permitted by contract, the fact that an advertiser may be deprived of relevant information as a result of that practice remains unchanged. Accordingly, K2 focused its fact-finding efforts on bringing to light non-transparent practices throughout the media-buying ecosystem, even if those practices were contract compliant.

Second, it is important to note that non-transparent business practices on the part of an agency may still result in effective media purchases that are truly in the advertiser's best interest; in other words, non-transparent does not necessarily mean sub-optimal. Rather, the key point – and the relevant point for this study – is that the lack of transparency makes it difficult, if not impossible, for an advertiser to *verify* the value and appropriateness of a particular media purchase. Accordingly, K2's focus throughout this study remained on the transparency or non-transparency of certain media-buying business practices as opposed to the efficacy of the purchases themselves.

2.3. Overview of Prior Transparency Studies

Over the past four years, a number of studies have addressed media transparency issues within the advertising industry and documented the erosion of trust between advertisers and agencies. In the interest of providing additional context for the findings contained in this report, these studies are briefly summarized below.

In 2012, the ANA conducted a survey of 180 ANA members.⁶ The survey revealed that 28% (50 respondents) were aware of media companies paying rebates/incentives to agencies within the U.S. for referring or influencing client spending. Eighty-five percent (153 respondents) believed that agencies should pass all rebates they received to their clients. However, only 34% (61 respondents) said that they had specific language in their U.S. contracts that required agencies to do so.

In 2014, the ANA and the research firm, Forrester, conducted a survey of 153 U.S. advertisers. This survey found that 46% (70 respondents) were concerned about transparency in media buys.⁷ Of the group expressing concern, 42% indicated that they had become more concerned in the past year, especially around practices like rebates, digital programmatic buying, and agency trading desks.

In another ANA/Forrester survey, published in May 2016, 88 ANA members were asked about non-disclosed programmatic models.⁸ The specific question was, “Have you opted into an undisclosed programmatic model with your agency/agency trading desk?” and a definition was provided.⁹ Forty percent (40) of the respondents reported that they were not sure. ANA members who confirmed that they had opted into non-disclosed programmatic models (34% of respondents) were asked why they had done so. Responses indicated an uneasiness about such a model. Representative verbatim responses included: “Only model currently available, but working on establishing an open model”; “Felt forced into it by the agency holding group, rather than opting in”; and “We leaped before we looked.”

Outside of the U.S., the World Federation of Advertisers (“WFA”) has also attempted to measure perceptions of transparency. In 2012, the WFA published a survey of members in Europe, Asia Pacific, and Latin America, regions where rebates are generally regarded as an accepted practice.¹⁰ The survey indicated that many advertisers suspect that their media-buying agencies do not pass on rebates to clients in full, either by way of cash or free advertising space.

In March 2016, U.K.-based media consulting group ID Comms published a global survey of 140 marketing, procurement, and agency professionals. The survey found that 71% (99 respondents) believed that the way an agency manages rebates is the most important factor in determining the level of trust that advertisers have in media agencies.¹¹

⁶ “Media Rebates/Incentives Require Full Transparency,” ANA, July 16, 2012. See: <http://www.ana.net/miccontent/show/id/wp-media-rebates-incentives>

⁷ “Media Buying’s Evolution Challenges Marketers,” ANA/Forrester, May 2014. See: <http://www.ana.net/miccontent/show/id/rr-2014-ana-forrester-evolution-of-media-buying-survey-report>. Respondents included advertisers drawn from the ANA’s membership with an average of 17 years of experience in the marketing/advertising industry.

⁸ “Programmatic Transformed Digital Media Buying,” ANA/Forrester, May 5, 2016. See: <http://www.ana.net/miccontent/show/id/rr-2016-programmatic>.

⁹ The definition stated: “An undisclosed programmatic model typically refers to an arrangement where an agent and/or intermediary purchasing media on an advertiser’s behalf does not disclose the actual closing/winning bid prices of media purchased, instead providing only a final price which includes margin and fees. By not disclosing the actual prices paid, margin are unknown and undisclosed to the client.”

¹⁰ “Media rebates remain high in many markets,” World Federation of Advertisers press release, March 22, 2012. See: <http://www.wfanet.org/en/global-news/media-rebates-remain-high-in-many-markets?p=62>

¹¹ “Media Transparency Survey Results,” ID Comms, April 11, 2016. See: <http://idcomms.com/media-transparency-survey-results>. About a quarter of all respondents were from the U.S.

3. Methodology

K2's independent assessment of transparency in the media-buying space was conducted from October 20, 2015 through May 31, 2016. Throughout the study, K2's work was guided by a number of key principles and utilized a set of carefully considered methodologies, all of which are described below:

- From the outset, the ANA made clear to K2 that the goal of the study was not to embarrass or accuse any individual or corporate entity of malfeasance. This unequivocal directive necessarily informed K2's fact-finding approach.

To that end, K2 provided every participating source with an assurance of confidentiality on two levels: (1) that the information provided by an individual source would not be attributed to that source in any communication to individuals outside of K2; and (2) that the names of individuals and corporate entities provided by a source would be anonymized in any report or outside communication in a manner sufficient to protect their identities. Accordingly, in this report, sources, individuals, and corporate entities are described but not named.

- On multiple occasions, sources expressed apprehension that their careers might be adversely affected if their participation in the study were to become known. In order to protect these sources and encourage open and honest participation, K2 provided each source with an additional layer of protection. K2 kept the identities of all participating sources – and all of the individuals and corporate entities named in their accounts – confidential from both Ebiquity and the ANA. This same protection also extended to sources who were approached by K2 but declined to participate in the study.
- As an additional protective measure, in the report that follows, all sources are referenced as “he,” regardless of gender. For similar reasons, K2 altered some of the actual dollar values¹² and/or percentages in transactions described by individual sources or in source documents but maintained the relevant monetary ratios in order to provide an accurate sense of scale.
- In keeping with the ANA's directive, at times K2 did not pursue certain lines of inquiry because doing so would have required the disclosure of corporate or individual names. For instance, K2 could not accurately trace the flow of funds in individual cases from a media supplier to an agency to an advertiser without revealing names and, therefore, declined to do so. Investigative and/or auditing work such as this was beyond the scope of the study.

¹² Please note that when dollar values were changed, they were only adjusted downward.

- At all times, K2 maintained complete control of every aspect of the fact-finding portion of the study. Ebiquity served as an industry expert and knowledgeable resource to K2 but did not participate in any of the source interviews. Nor were any Ebiquity employees used as sources (i.e., providers of factual information). Further, as described above, Ebiquity was at no time given access to any un-redacted source documents or interview notes that might have contained the names of any sources or relevant individuals or corporate entities. Rather, Ebiquity's primary role in the study was to review K2's factual findings and use them as a platform to develop practical solutions and best practices to serve as industry standards.
- In structuring this study, K2 attempted to construct a list of knowledgeable individuals representing a cross-section of the media-buying ecosystem. K2 assembled this list using the following sources:
 - Individuals known to Ebiquity and/or the ANA;
 - Individuals known to K2;
 - Individuals identified through independent research conducted by K2;
 - Individuals recommended to K2 by other sources;
 - Individuals who responded to a confidential 800 number and/or e-mail address established and maintained by K2;¹³ and
 - Individuals recommended by the American Association of Advertising Agencies ("4A's").
- Over the course of the study, K2 requested interviews with 281 sources and ultimately conducted 143 interviews with 150 individual sources.¹⁴ The sources break down into the following categories:
 - 29 advertisers;¹⁵
 - 57 media suppliers and ad tech vendors;
 - 38 agency professionals, both current and former, including representatives of all Agency Holding Companies;
 - 10 trade association representatives; and
 - 16 other individuals (consultants, industry legal counsel, independent barter company employees, post-production professionals)

Of these 150 sources, 136 were focused on the U.S. market, while the rest did business primarily in foreign markets. Of those 136 sources, 117 had professional backgrounds that provided them with direct knowledge of the media-buying process (i.e., advertisers, media suppliers and ad tech vendors, agency employees, and media consultants).

Some sources offered perspectives in more than one category (e.g., an advertiser who previously worked at an agency); however, such sources were counted only once in the tally above and were included in the category in which they offered the most relevant information.

¹³ In a statement dated January 29, 2016, the ANA called upon "industry executives with relevant insights to confidentially come forward and volunteer their perspectives." The press release promised both confidentiality and anonymity and included a telephone number (800.645.3083) and an e-mail address (mediatransparency@k2intelligence.com). Both remain active at the time of this writing. "ANA Calls Out 4A's For Releasing Media Transparency Guidelines It Deems 'Premature,'" *TheDrum*, January 29, 2016. See: <http://www.thedrum.com/news/2016/01/29/ana-calls-out-4a-s-releasing-media-transparency-guidelines-it-deems-premature>

¹⁴ Some interviews included more than one source, and ten sources were interviewed more than once.

¹⁵ K2 interviewed advertisers from a range of industries, such as financial services, food/beverage, pharmaceutical, personal care, clothing, and telecommunications.

- Of the 131 individuals who were not interviewed by K2, 61 declined K2's interview request and 70 did not respond to phone messages, e-mails, or both. Five of the six major agency holding companies and their affiliated companies declined formal requests to make any of their executives available to be interviewed.
- Source interviews were conducted by teams consisting of two K2 professionals, all with extensive experience conducting interviews and assessing the credibility of sources. The majority of these interviews were conducted in person, while others were done telephonically or by videoconference, depending upon the source's availability. In-person interviews took place in either K2's offices, at the source's place of business, or at a neutral location (e.g., restaurant, coffee shop), depending upon the source's availability and preference. Following each interview, a detailed memorandum was drafted in order to memorialize the content of the interview.
- For each source, K2 undertook a series of steps designed to ensure the credibility and accuracy of the information they provided. Those steps included, but were not limited to, the following:
 - Targeted public records and open source research prior to each interview in order to better understand the source's personal and professional history, basis of knowledge, and any possible bias and/or motivation;
 - Analysis of the internal consistency and level of detail of the source account;
 - Analysis of whether the source account was consistent or inconsistent with the accounts provided by other, independent sources;
 - Analysis of whether the source account was consistent or inconsistent with information contained in public record sources;
 - Analysis of whether the source account was corroborated by documentary evidence provided by that or another source; and
 - Follow-up interviews to clarify key points.
- At no time during the study did the ANA place any substantive restrictions on K2's fact finding. At all times, K2 maintained complete authority over the methodologies utilized by the study team, as well as full editorial control of this report.

4. Findings

4.1. There Is A Fundamental Disconnect In The Industry Regarding The Basic Nature Of The Advertiser-Agency Relationship

During the course of this study, K2 interviewed 29 advertisers and 38 current and former agency employees regarding their perceptions of the basic nature of the advertiser-agency relationship. Neither agency professionals nor advertisers in K2's sample expressed a uniform opinion as to how their relationship should be defined, or how it actually operates. Rather, there is substantial disagreement both within and between these groups about whether and when agencies are obligated to act in the best interest of their clients (i.e., as their fiduciaries).

4.1.1. Advertiser Perspective

A substantial majority of advertisers conveyed to K2 a belief that their agencies are, in fact, their agents and, as such, duty-bound to act in their best interest. Many advertisers also expressed a belief that this obligation – essentially, in their view, a fiduciary duty – extends beyond the explicit terms in their agency contracts. One senior executive who heads global digital marketing at a global advertiser stated: “Spiritually, my agency is meant to be working on our behalf. By that, we mean obligated to act in our best interest. My agency has to be my agent.” A media manager at another global advertiser added: “I don't have the man hours to look at every single item [on my agency's post-campaign reports]. I have to trust that the agency is doing the best thing on my behalf.” Another senior media executive told K2: “Their biggest role is as media specialists who help us find where our target audiences are and how we can reach them, and then negotiate on our behalf to get us the best possible prices [for media] and do what's right for [our company]. [Agency]¹⁶ acts as our agent, with our best interests at heart.”

Not only did many advertisers believe that agencies were duty-bound to act on their behalf, they also believed that they shared a true partnership with their agencies. A senior executive who manages agency relations at a global advertiser stated: “We are partners, and I can't imagine that we would be paying an agency to work on our brands and their interest be on something other than delivering against our expectations.” The head of marketing for an advertiser focused in the North American region added: “Our understanding is that we have a partnership, and everybody wants to be good partners.”

In contrast to the above, a senior executive who led the integration of all business units for a manufacturing and processing conglomerate stated: “There is no fiduciary relationship. They're selling us stuff. In all my 20-plus years, I never felt that, ever. I always felt like we were getting sold stuff.”

¹⁶ The name of this agency has been anonymized.

4.1.2. Agency Perspective

In January 2016, the 4A's issued "Transparency Guiding Principles of Conduct" which "outline recommended behaviors to inform client and agency agreements."¹⁷ Within this document, the 4A's provided that: "The default principle in all client/agency relationships where the agency is agent and the client is principal is full disclosure and full transparency in media planning and buying, unless there is an exception that the client has agreed to in advance and is covered by a separate agreement. Further, the client/agency agreement should specify that the client is the principal and the agency is the agent."¹⁸ Nevertheless, despite this "default principle," the 4A's acknowledged that agencies may also act as principals: "The agency should always ensure that the client clearly understands the nature, implications and benefits of any opt-in products and services, including disclosed and non-disclosed models. These should be documented with an opt-in agreement, with a clear explanation of any implications for audit rights, access to the agency's underlying costs and whether the agency is acting for the client as its agent or as [a] principal."¹⁹

As noted above, K2 interviewed a number of current and former members of the agency community during the course of this study. Some agency executives made clear that they believed they owed not only a legal, but an ethical, duty to their clients to act in their best interests; however, many other agency executives expressed a different view of the advertiser-agency relationship.

A former senior executive at an Agency Holding Company told K2: "I really believe the agency is duty-bound to do the best we possibly can for our clients, beyond what the words of the contract say. Like any other relationship, or even marriage, you want it to be a mutual partnership: the agency looks after the client to the best of its abilities and capabilities. At the same time, you want the client to be supportive of the agency as much as it can be." Another former senior executive at an Agency Holding Company informed K2 that the culture at his agency was very "old school" in that "we only act on the advice and counsel of our clients – it's their best interests that we have in mind completely."

These sentiments were not limited to executives at the holding company level. A number of employees at agencies affiliated with Agency Holding Companies also expressed to K2 that their duty was to act in their clients' best interests. The former CEO of a media agency stated: "If you don't consistently demonstrate you're acting in the client's best interests, it's almost a foregone conclusion that you will lose that client." Similarly, a media executive at another agency asserted that his firm was "generally advised to work in the best interests of clients." He added that his agency would "often go above and beyond what the contract stipulated" in service of their clients.

Members of the independent advertising community provided similar opinions. A current C-level executive at an independent agency asserted: "There's a moral responsibility of trust in that client relationship. Clients need to know about any conflicts of interest you have, and you need to tell them about it, so they can make an informed decision. I don't want my clients ever to think I'm not doing something that's not in their best interests. So if I've set something up as a separate interest, I'd like them to be aware of it." And, a current

¹⁷ "The 4A's Issues 'Transparency Guiding Principles of Conduct,'" The 4A's, January 28, 2016. See: <http://www.aaaa.org/news/bulletins/Pages/The4AsIssuesTransparencyGuidingPrinciplesofConduct.aspx>

¹⁸ *Ibid.*

¹⁹ *Ibid.*

CEO of a smaller independent agency stated that there is an “implicit agreement” that his agency acts in the best interest of his clients rather than it being spelled out in formal contract language.

Notably, many other members of the agency community interviewed by K2 disagreed with the views described above. As an example, the current CEO of an Agency Holding Company described his understanding of an agency’s main responsibility to a client as to “be consistent with what they want from us and on a transparent basis.” He also stated that, “There’s nothing wrong with something if the contract agrees to it.”

Other agency sources noted the potential for conflict inherent in trying to serve the interests of their clients and shareholders of the Agency Holding Company at the same time. One former senior executive of an Agency Holding Company stated that the obligation of an agency is to act in the client’s best interest, but that the obligation of a holding company is to act in the best interest of the business operations it oversees. According to this executive, agencies have recently become “more and more beholden” to Agency Holding Company interests over client interests. Another former C-level agency executive reported that buying decisions at his former agency were increasingly made at the Agency Group level rather than by the individual agencies. In his opinion, this centralization of decision-making power took “authority and autonomy” away from planning teams and buyers. This allowed the Agency Group to direct buyers to purchase from specific media suppliers that provided the largest margins, thereby fostering an environment in which buying decisions were “completely” driven by the potential profit for the Agency Group.

Similarly, the former CEO of an Agency Group said that the idea of an ad agency serving as an agent is an “outdated concept.” He added that advertisers want “brand success and good service,” but then they “send in procurement to hack away at CPMs and pricing,” which he said fosters “misaligned incentives.”

In sum, based upon dozens of interviews of current and former agency personnel, as well as dozens of advertisers, it is clear that there is a fundamental disconnect in the industry regarding the basic nature of the advertiser-agency relationship. Neither agencies nor advertisers have a uniform opinion as to how their relationship should be defined or how it actually operates; rather, there is substantial disagreement both between and within these groups.

4.1.3. Contractual Language Regarding Advertiser-Agency Relationship

K2 interviewed more than 20 sources about their experience with contractual provisions regarding the advertiser-agency relationship and actually examined several relevant excerpts from advertiser-agency contracts. In practice, it appears that many advertiser-agency contracts allow for the agency to act as both agent and principal, depending upon the situation. Former agency executives, advertisers, and media consultants reported that it is common practice in the U.S. for agencies to include caveats within contracts, or ask clients to sign addendums to existing master service agreements, that permit agencies to change their posture from agent to principal for specific products or services with non-disclosed models (i.e., the cost of the original media is not disclosed), including programmatic media-buying.

One former Agency Group executive told K2 that agency addendums to client contracts permitted practices that, in his opinion, most clients did not anticipate. Such practices included charging non-disclosed markups on tech fees from programmatic partners and/or directing client spending to entities in which the Agency

Holding Company is invested. Similarly, a former chief marketing officer at a global advertiser reported that he signed a contract addendum to an MSA that permitted his agency to engage in non-disclosed buying. The source indicated that he agreed to the addendum with a sense of unease over the lack of transparency with regard to underlying media costs, but that he did so because the addendum promised – and delivered – lower rates for media.²⁰

K2 examined an advertiser-agency agreement, involving another global advertiser, which contained a clause securing the agency's right to buy media from affiliated entities, including a barter division and an ATD. According to a section of the agreement on "inventory media services," these entities purchase and sell media after adding a markup, "essentially acting as any other supplier" with whom the AOR negotiates on the client's behalf. The advertiser's U.S. media manager told K2 that he was concerned that the contract imposed few constraints on the agency's capacity to act as a principal. He indicated that he hopes to address this issue when the agreement is next under review.

K2 reviewed excerpts from two additional advertiser-agency contracts, both global but covering U.S. media spending, which refer to "inventory media." According to the media consultant who provided these excerpts to K2, the term "inventory media" generally refers to advertising placements that an Agency Holding Company buys on its own account, most likely at heavily-discounted rates by virtue of its purchasing power with media suppliers. In both contract excerpts,²¹ two agencies from separate Agency Holding Companies state that their prices are guaranteed only if the client agrees to terms and conditions that include allowing the agencies to acquire inventory media "without purchase authorization" from the client. The consultant understood this to mean that the agencies would not be required to inform their clients whenever they added "inventory media" to a media plan. "It could give an agency license to load up media plans with this inventory without having to account for its provenance," he said.

4.2. K2 Found Substantial Evidence of Non-Transparent Business Practices in the U.S. Market in the Form of Rebates

4.2.1. Overview

During the course of this study, K2 interviewed numerous sources who reported that agencies and Agency Holding Companies are receiving rebates from media suppliers in the U.S. market. K2 also obtained significant documentary evidence that corroborated many of these source accounts. Forty-one (41) individuals interviewed by K2 reported that they had firsthand knowledge of such deals. Of those 41 sources, 34 reported indicia that the rebates were not disclosed to advertisers, were not passed through to advertisers, and/or were demanded by agencies. Twenty-three (23) of these individuals had experience working at ad tech firms or media suppliers, and 11 had experience at media agencies.²² K2 identified

²⁰ Other advertisers told K2 that they put clauses in their client-agency contracts forbidding their agencies from engaging in any form of non-disclosed programmatic media-buying because they were not willing to trade cheaper prices for transparency.

²¹ K2 understands the agencies in these agreements are positioned as agents but act as principals in some digital media-buying arrangements.

²² Please note that of the 41 individuals interviewed who reported experiences with rebates, some of them had experience in more than one area of the ecosystem (e.g., a source who worked for both an agency and a media owner). These sources were counted for each of the categories for which they provided relevant information.

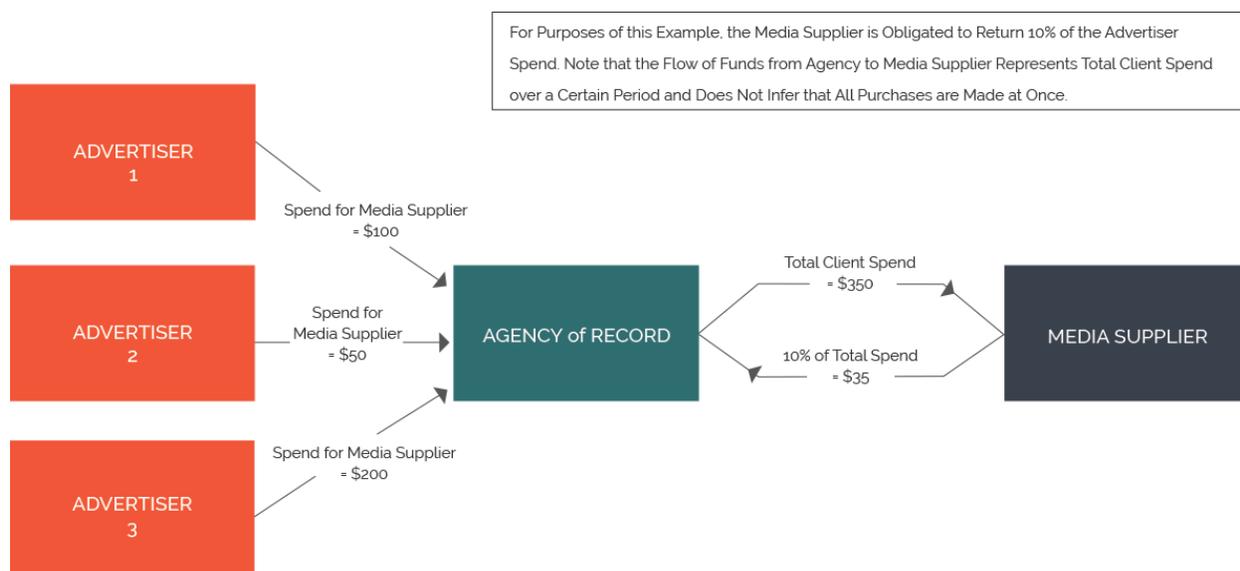
evidence of several methods by which these rebate deals are structured, all of which are described below.

For purposes of this study, the term “rebate” broadly refers to a benefit that a media supplier provides to a media agency, or an entity within an Agency Holding Company, representing a portion of the amount that an agency, or an entity within an Agency Holding Company, spends on media purchases with that media supplier. Benefits can include cash, free media inventory, debt forgiveness, equity or contingent equity,²³ and/or other forms of non-cash benefits. In certain instances, examples of which are discussed below, a rebate is paid not to the AOR but to an affiliated entity within the same Agency Holding Company. This definition also draws a distinction between a rebate and a discount in that a discount is typically a price reduction applied to inventory at the point of sale, while a rebate is paid retrospectively.

4.2.2. Rebates in Cash and Free Media

Subjects who reported firsthand experience with rebates indicated that these agreements included financial incentives for the agency in the form of cash or free media.

Diagram A: Flow of Funds in a Cash Rebate Transaction



Among the sources who stated that rebates are provided to agencies in the U.S. market was an executive at a large online media supplier who described a cash rebate program currently in operation at his company. According to the executive, several years ago the media supplier proactively established an incentive

²³ Contingent equity refers in this instance to stock options or warrants.

program designed to encourage agencies to direct a greater amount of spend toward a certain type of this media supplier's ad space. The media to which this program applies is purchased at a pre-negotiated and fixed cost, rather than on a public exchange. The incentive program, which is open to individual agencies, establishes certain thresholds for both overall spend and year-over-year growth, above which agencies receive a cash rebate at the end of the year. The metrics required to trigger the rebate, and the percentage of rebates provided, are determined on an agency-by-agency basis. According to the executive, the rebate received in the U.S. is linked to the volume of U.S. spend; at the end of the year, the media supplier sends each agency a spreadsheet detailing its total annual spend by advertiser and noting the rebate generated by each advertiser's expenditure. He stated that agencies at Agency Holding Companies received rebates in this program and noted that all rebates provided through this program were transmitted in cash.²⁴

During the interview, K2 noted that certain Agency Holding Company executives have stated publicly that rebates do not occur in the United States. In response, the source stated that, based upon his conversations with agency staff, he believed that the agencies that received rebates from his company were "absolutely" passing the benefits back to their clients. In an attempt to reconcile these public statements with the rebate program, he opined that perhaps the agencies do not consider these cash back payments to be rebates, since the agencies have said they are passing the funds back to their clients. The source reiterated that the only basis for his belief that the funds were being returned to the clients was what the agencies had told him. K2 did not attempt to verify whether these rebates were, in fact, being provided to advertisers in order to avoid compromising the executive's confidentiality.

A C-level executive of an Agency Holding Company provided a seemingly contradictory statement regarding the existence of rebates in the U.S. market. According to the source, "rebates do not exist in the United States, though they are common in some international markets." The source further stated that "rebates' are commonly understood to be a source of value directly triggered by, and tied to, client spending volume (such as traditional AVBs)." However, the holding company executive's description of rebates would appear to encompass the cash payments described by the large online media supplier executive cited above.

Other sources described similar deals involving smaller independent agencies. An ad tech executive provided K2 with a copy of a rebate contract between his company and an independent agency effective for the 2015 calendar year. The contract included a provision for the payment of a "referral fee" representing 10% of agency spend, which the ad tech executive described as a rebate by another name. The executive also provided K2 with internal company emails from the period in which the deal was being negotiated. In these emails, the ad tech company employee in charge of managing the agency relationship reported that the agency wanted to make a profit from the ad tech firm and was therefore requesting a rebate of 10% up to a certain spend threshold and 15% above that threshold. The agreement was to be active through the rest of the calendar year with the rebate to be paid in the first quarter of the following year. The ad tech company signed the agreement, the executive said, since the agency conducted most of its work in a

²⁴ The executive noted that the rebate program was separate and distinct from price discounts that his company sometimes negotiated on a campaign-by-campaign basis. He also drew a distinction between the rebate program and strategic partnerships that the company had established with certain agencies that included initiatives like joint product development aimed at driving innovation in the industry.

strategic area of the marketplace in which the ad tech company wanted to expand.

A former Agency Holding Company executive who left within the last two years reported to K2 that he had direct knowledge of multiple cash rebate deals at his former Agency Holding Company. According to this source, in the wake of the press coverage of former Mediacom CEO Jon Mandel's March 2015 presentation at the ANA's Media Leadership Conference,²⁵ these deals were restructured at the request of other Agency Holding Company executives. Specifically, the benefit passed back to the Agency Holding Company was reformulated from a cash payment to a discount applied to the price of inventory on the front end and was made available only to clients that had opted into a non-disclosed buying agreement. The executive reported that, during the period when the cash rebate deals were active, the counterparty companies were put on an internal "hit list" of entities to which spend should be pushed. He reported that, in general, rebates were passed back to clients "about half" of the time, depending on how cost-conscious the client was.

In his interview with K2, the former Agency Holding Company executive reported that his holding company had global rebate or discount deals with several major online media suppliers, including the large online media supplier discussed above. The former executive reported that deals with these large media suppliers were negotiated on the holding company level; for this particular online media supplier, he reported that the holding company received a financial benefit of approximately 10% of total spend. He reported that, at his former holding company, this type of deal was typically "sectioned off," in that the manner in which rebates were transmitted back to the holding company varied by jurisdiction, based upon the accepted practices in each jurisdiction. For instance, in some countries the company received cash rebates while, in the U.S., agreements were typically structured using a tiered discount model with escalating benefits linked to volume of spend. In the opinion of this executive, in instances where discounts are not passed on to clients, the difference between "rebate" and "discount" was a "semantics game," as "it's ultimately making the same amount of money off of a client."

The head of an independent agency told K2 about a meeting he had approximately 10 years ago with an Agency Group. During the meeting, a senior executive at the Agency Group told the source about various ways one of its agencies was making "grey revenue" from U.S. media spending. This included not returning media rebates to clients and keeping payments for unbilled media (i.e., moneys received from clients for which they have not received an invoice from the media supplier), after placing them in escrow for a period of time. K2 reviewed a contemporaneous memorandum of this meeting, prepared by the source's counsel, which corroborated the source's account in detail.

Several current and former ad tech executives and media suppliers also said that they had deals with agencies to pass back free media at the end of the year, with explicit provisions that this media could only be used for the client who spent with them. These sources did not have direct knowledge of whether the free media was in fact passed back to clients. K2 did not attempt to verify this particular assertion in order

²⁵ In a speech delivered at the ANA Media Leadership Conference in March 2015, Mandel alleged that the practice of undisclosed rebates in the U.S. was widespread, triggering further debate around media transparency. For more information, see: "Former Mediacom CEO Alleges Widespread U.S. Agency 'Kickbacks': At ANA Forum, Mandel Details Practices He Puts Among Reasons He Left Agency World," *Advertising Age*, March 6, 2015; "GroupM Responds to Industry Rebate Allegations: Norman: 'Rebates Or Other Forms of Hidden Revenue Are Not Part' Of Group's Trading Relationships," *Advertising Age*, March 6, 2015; "Media-Agency Kickbacks. Yes, They're Real. Secret Rebates, Sketchy Services and Offshore Deals. Inside the Murky New World of Ad Buying," *Advertising Age*, March 23, 2015; "Jon Mandel and the ANA Seven Months Later: Smoke but No Fire," *Media Village*, October 5, 2015.

to avoid compromising the confidentiality of these sources.

Among those individuals who reported firsthand knowledge of rebate deals, several noted that the deals in which they participated had been proposed by the media owner paying the rebate in order to drive volume. Examples include the following:

- A former agency employee reported that rebates have been proactively offered by ad tech companies. As an example, he provided K2 with emails between a representative of an ad tech firm and several employees of his former agency. In these emails, which were sent within the last two years, the ad tech representative offered to provide a financial benefit back to the agency based upon spend from the agency during a single fiscal quarter. The email offered to structure the benefit variously as an upfront discount on the price of all media purchased; as a cash rebate; or as a bonus (with, for example, \$6 million worth of media provided for \$5 million in spend).²⁶ The ad tech representative suggested that, if the agency wished to receive a cash rebate, it could either pass the cash back to clients or keep it as a technology fee in order to meet internal revenue goals. The ad tech representative claimed in this email that multiple other Agency Holding Companies had already agreed to enter into similar agreements. When questioned as to whether rebates were returned to clients, the former agency employee told K2 that, to his knowledge, these funds were sometimes returned to clients and sometimes kept by the agency in order to meet periodic revenue targets.
- A former executive of a media supplier similarly reported that his former company offered rebates to agencies in order to drive business. “Every discussion we had was around price because we were begging to get on the media plan,” he said. The company reportedly offered discounted pricing and also issued media “credits” to agencies in exchange for volume spending, which could be used for any client.
- A former C-level executive at a digital media supplier reported that, in 2014, his former company initiated a rebate-related deal covering the U.S. spend of an Agency Group. Under the terms of the deal, a certain level of aggregate spend among the Agency Group’s member agencies triggered the award of a quantity of free media from the Agency Group. At the spending threshold, which was in excess of \$5 million, the Agency Group was awarded just over 10% of spend back in free inventory. The executive stated that he understood that the free media would be allocated to the clients whose spending generated it, though he did not know how it was ultimately apportioned. The executive reported that he asked for a paper contract and was informed that the Agency Group responded that “verbal was fine.”
- A senior executive at a magazine publisher reported that he was engaged in negotiations with an Agency Group to finalize a similar rebate deal, which would provide the Agency Group with free media linked to spend at a certain monetary threshold. The executive reported that, “if you’re trying to turn around an aging [media] property, these [rebate] deals are beneficial.” He noted that his company was “scraping and clawing for every dollar we can” and that he felt no pressure from agencies to enter into rebate deals. “The pressure was from me,” he said.

²⁶ K2 notes that, depending on how this was billed, this could be provided as a rebate or as a discount.

K2 identified an additional instance in which a contract between two agencies explicitly addressed the issue of rebates. K2 reviewed a copy of a media authorization signed two years ago by an independent media agency and an independent OOH media agency that it had subcontracted for OOH services. The authorization relates to the purchase of outdoor advertising space, ultimately on behalf of an advertiser. The media authorization states that the media agency “acknowledges” that the OOH agency is “entitled to, and will retain” any rebates it collects from OOH media suppliers. The source who shared a copy of this contract with K2, and who has knowledge of the incident, said he learned from the advertiser that it was unaware of this rebate clause and did not benefit from any rebates. The source told K2 that the advertiser only discovered the rebate clause when it asked the media agency to hand over documents relating to its ad spend.

4.2.3. Rebates Structured As Service Agreements

As noted above, in January 2016, the 4A’s released their “Transparency Guiding Principles of Conduct,”²⁷ detailing suggested guidelines related to transparency among market participants. Among these were several principles related to commercial relationships between agencies and media suppliers, including agreements whereby agencies receive payment for “services provided, such as barter, content production or research projects.”²⁸ The principles noted that “these commercial relationships reflect services provided by the agency, are kept separate and do not promise or commit to client spending.”²⁹ They continued, “It should be clear that the agency’s commercial transactions do not influence communications and media planning and investment recommendations for the client, which should be done on behalf of the client and according to the client’s stated objectives.”³⁰

During the course of this study, K2 spoke to multiple sources with direct knowledge of service agreements. According to these sources, under the terms of the agreements, fees for the services – usually described as consulting or research – are actually tied to the cumulative volume of agency spend rather than the scope of work or the expenditure of time and materials. The majority of sources also reported that services were of minimal utility, significantly overpriced, or not provided at all. K2 found no evidence to suggest that the proceeds of these service agreements were returned or disclosed to the agency’s clients.

Of the pool of individuals interviewed during the course of the study, 20 provided first-hand knowledge of service agreements, and 18 of those sources were focused on the U.S. market. Approximately half of these sources were from the ad tech sector, with the remainder coming from agencies and media suppliers. The majority of the sources who discussed this practice were critical of it, with criticisms falling into two general categories:

- (1) Ad tech sources consistently reported that they understood service agreements to be an explicit or implied prerequisite for inclusion on the “preferred vendor” list of an agency or Agency Holding Company. As a corollary, sources also understood that exclusion from an agency’s preferred vendor list would make it difficult if not impossible to do business with that agency. Media suppliers

²⁷ “The 4A’s Issues ‘Transparency Guiding Principles of Conduct,’” The 4A’s, January 28, 2016. See: <http://www.aaaa.org/news/bulletins/Pages/The4AsIssuesTransparencyGuidingPrinciplesofConduct.aspx>

²⁸ *Ibid.*

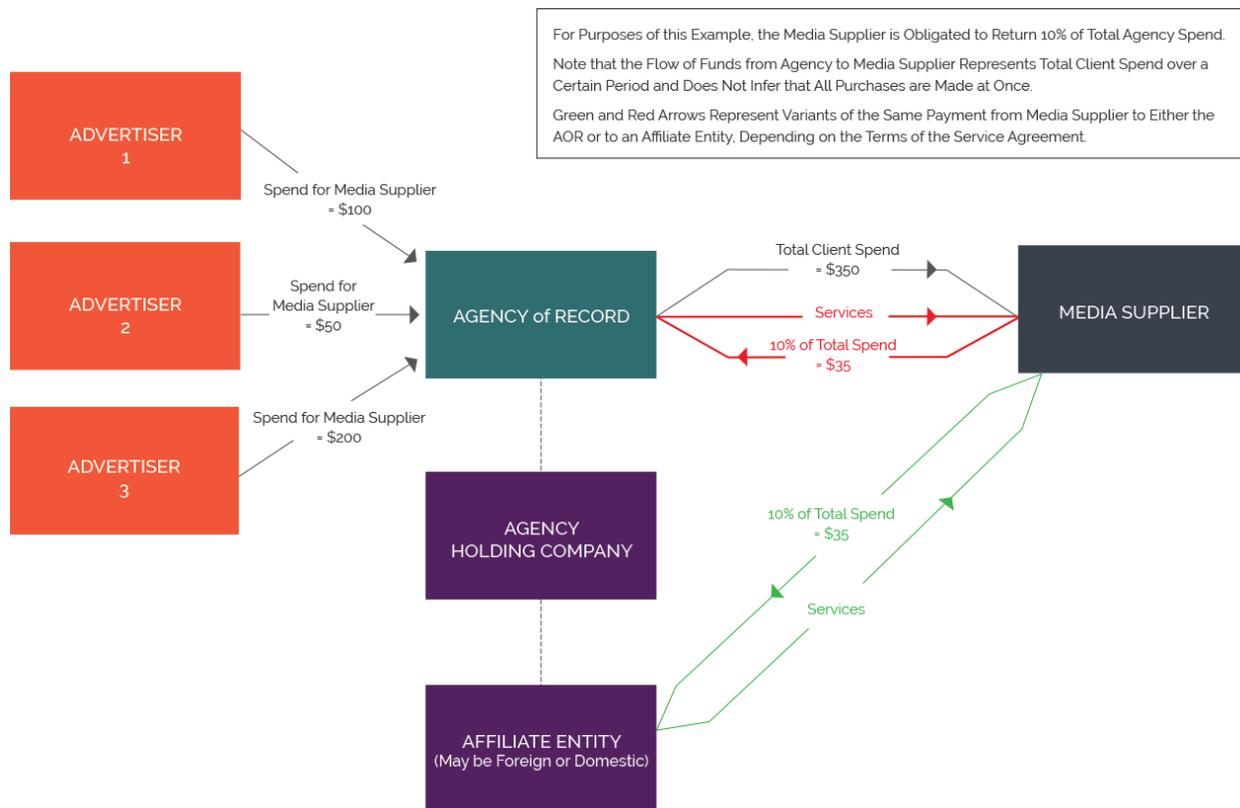
²⁹ *Ibid.*

³⁰ *Ibid.*

who reported paying what they classified as inflated rates for research reports similarly expressed their perception that the payments constituted a *quid pro quo* for agencies directing client spend to their companies.

- (2) Several of the ad tech sources reported receiving services under these agreements that they found to be of some utility. However, the majority of these sources reported that the services for which they contracted were either of limited value or were not provided at all; many expressed the belief that the service agreements were being used to obscure what was essentially a rebate.

Diagram B: Flow of Funds in a Service Agreement Transaction



Among the sources critical of service agreements were executives from four different ad tech companies, each of whom independently described being asked by the same agency to enter into service agreements within the last three years. Each source also provided copies of these agreements for K2's review. According to these sources, all of the agreements were drafted between early 2013 and late 2014.

Three of the agreements were negotiated through the same U.S.-based office of the agency and shared certain common characteristics (the fourth agreement was negotiated outside of the United States, and is

discussed further below). All three agreements:

- Listed the same counterparty: i.e., a non-U.S. affiliate of the Agency Holding Company;
- Were titled “Services Agreement” and described the services to be rendered by the agency in general terms, such as “planning” and “media coordination”;
- Specified that a percentage of spend directed to the ad tech companies by the agency was to be returned to the foreign entity in cash. Two of these agreements were structured in tiers, with a greater percentage rebate linked to a higher volume of spend. The third was structured as a straight percentage rebate that remained fixed regardless of volume. Rebate percentages varied between 5% and 20% across the three agreements.

The three ad tech executives linked to the U.S. agreements all independently reported to K2 that they understood – through either direct statements or innuendo from agency representatives – that they would not receive business from the agency if they did not enter into these service agreements. One executive provided K2 with an email from an agency employee stating that, since the service agreement had not yet been executed, the agency had been “unable” to “push” the ad tech company for business and could not “encourage” teams to use the company until the contract had been signed. Two of the three ad tech executives ultimately signed the agreements, while the third did not.

Of the two executives who entered into these agreements, one stated that “there was zero value other than just being considered for buying or not.” The other reported that he “never had any contact with [the foreign entity]. Not only did they not provide any services, there wasn’t even a contact person. We were just meant to write them a check.”

The executive whose company opted not to sign the agreement provided K2 with email communications between two agency employees involved in the contract negotiations and several executives at the ad tech company. In these communications, both sides referenced the fee to be paid to the foreign entity as a “rebate.” The executive stated that, after his company’s decision to decline the agreement, agency teams “would not take meetings” with his company, and he received what he characterized as a very low level of business from the agency.

As noted above, a fourth agreement was negotiated through a non-U.S. office of this same agency. This agreement is currently active. An executive of the ad tech company that entered into this agreement reported that, though the contract was negotiated abroad, it covered the agency’s spend on a global level, including in the U.S. While the agreement was described as a “trading agreement” rather than a “services agreement,” and included a more detailed list of services to be rendered by the agency in exchange for the rebate, it named the same non-U.S. counterparty as the three agreements previously discussed and was similarly structured as a cash rebate of approximately 20% based upon the volume of the agency’s spend. The services included in this agreement included meetings, calls, and other activities which, the executive said, he hoped would provide an introduction to agency staff in order to drive business. These activities occurred but did not lead to an increase in business. The executive reported that it was his clear understanding that the contract was a rebate agreement with some token “services” attached that functioned as a prerequisite for the receipt of agency business.

This same ad tech executive reported that, in late 2015 (a time when the contract was not due to be renewed or re-negotiated), the agency approached his company to “convert” the agreement. According to internal company emails provided to K2, a senior employee of the ad tech company reported to his colleagues that an agency employee told him that the agency wished to replace all trading agreements with the updated “service agreements.” A template of the new agreement, shared with K2, listed a different non-U.S. entity as the counterparty and an amended list of services, including services related to digital ad performance, verification, and strategy. These were entirely different from the services listed on the previous agreement. The executive told K2 that these services would have been “not at all” useful to his company and were “not anything we would buy from them.”

As of the time of his interview with K2, this executive had not agreed to the terms of the new deal. He stated that he understood that the agency wanted to keep the underlying financial terms of the current “trading agreement” and believed that the new agreement was just an attempt by the agency to hide a rebate.

Others who had similar agreements with other holding companies or agencies reported similar concerns regarding the perceived necessity of entering into these agreements in order to become a “preferred partner” of a particular agency, as well as the value of the services purchased. An ad tech vendor who entered into a service agreement with a separate holding company reported that the implicit message of these agreements was, “If you don’t do this, then the media recommendations will not include you.” He stated, “The power of the media recommendation is the primary leverage that agencies leverage over vendors.” Another stated, “The money that we paid was for real services, but were those services worth the price? No, of course not.”

The media suppliers who discussed this practice discussed purchasing research reports from an agency or Agency Holding Company. Three media suppliers reported paying agencies for research studies, although they held differing viewpoints on the usefulness of this material. One of these individuals stated that there was “real value” in the studies he purchased but believed he had overpaid. He stated that, ultimately, he was “happy to pay my friends for spending money with me.”

Another of these media suppliers who operates in the OOH space reported that he currently has what he classified as rebate agreements with two Agency Holding Company OOH affiliates. This individual stated that he paid “six-figure sums” for a series of market research reports, each about ten pages in length, which were worthless to him. This media supplier stated that he received regular invoices for “market research” services tied to the volume of aggregate client spend. He stated, “If I could do without it, I would. If I could deal with the agency of record directly or with the client directly, I would ... But I’ve said ‘yes’ to these deals because I know that if I don’t, a competitor down the street will get the business instead of me.”

Several former agency executives and an OOH media supplier discussed a variation on the service agreement method that is specific to OOH buying. One of these former agency executives reported that, in the late 2000s, his holding company’s OOH agency developed a program with media suppliers in which the media suppliers returned a percentage of the Agency Holding Company’s spend in order to fund certain “research tools” that were ultimately of value to the agencies and to their clients. He stated that, in his opinion, the fee was warranted because legitimate services were provided.

Another former executive at an OOH agency at the same Agency Holding Company provided a similar

accounting of this program and noted that the standard service fee was 1.67%. This executive stated that, although services were provided in the early years of the program, they had effectively ceased over the last five years, while the fee charged to vendors remained in place. In the opinion of this former executive, the program had effectively become a rebate program.

An OOH media supplier who participated in a service agreement with the OOH agency described above provided K2 with a copy of his 2012 contract. Under the terms of the contract, the media supplier was due to pay the buying group a 1.67% commission. In return, the OOH agency would create research tools to support the OOH advertising market and provide the media supplier with news updates, periodic reports on industry issues, and other materials. The media supplier stated that his principal motivation for entering into the deal was to secure payment terms; under the terms of his deal, the holding company buying entity was required to pay him within 60 days in order to qualify for the discount. In exchange for these favorable payment terms, the media supplier stated that he was “happy to pay” the 1.67%.

4.2.3.1. *Non-U.S. Service Agreements*

While the focus of this study was on practices within the U.S., K2 interviewed an executive of an ad tech company located in the U.S. – but doing business in non-U.S. markets – who provided K2 with documentary evidence of an Agency Group reclassifying rebate agreements as service agreements. The executive also expressed a belief that this practice was a method of concealing rebates, suggesting that they were not being passed back to clients.

The executive provided emails from employees of an Agency Group, sent within the last two years, in which the employees negotiated a cash rebate to be paid to the Agency Group. The executive explained that the rebate was based on non-U.S. spend; it was structured as a flat percentage of Agency Group spend with no minimum spend threshold. One of the Agency Group’s agencies subsequently issued an invoice to the ad tech company, a copy of which was provided to K2. The invoice lists the amount due as “services,” while the executive reported that it, in fact, represented the rebate for this non-U.S. spend. The executive also provided several other invoices from agencies affiliated with this holding company for “consulting services” or “agency fees” related to non-U.S. spend during the last three years and stated that these also represented rebates instead of payment for services rendered.

The executive reported that, within the last two years, he has also paid rebates to another Agency Group. Those rebates are structured, at the Agency Group’s request, as a combination of a cash rebate memorialized in a written contract and a second, larger payment for “services” that is negotiated orally and not memorialized in a contract. Both of these payments are structured as a percentage of total Agency Group spend. The “services” provided are not useful, the executive reported. In one recent year, he stated, the Agency Group provided him with multiple copies of a “useless” research report that “immediately went into the trash.” The executive stated that he paid at least twice as much to the Agency Group in the form of services as compared to cash rebates.

The executive argued that the categorization of these rebates as services implied that the funds were not being passed back to clients. “Why, then, do agencies ask that only a 5% rebate be documented in writing, while the other 25% rebate is collected in an invoice for shady services?” he stated. “The agencies are trying to hide that money. And they make it clear that we are not to discuss rebates with the client.”

4.2.4. Contractual Rebate Provisions

K2's limited review of advertiser-agency contract language, and interviews of advertisers and several media consultants with experience reviewing such contracts, indicated that these contracts vary considerably with regard to provisions pertaining to rebates or any other financial benefits generated from client media expenditure. K2 obtained an excerpt from one global advertiser-agency contract in which the definition of media "discounts" was extensive, running to 14 lines; another contract's definition of "AVBs" (an acronym for "Agency Volume Bonuses") ran to 12 lines. By contrast, an advertiser at a U.S. non-profit organization, which hires agencies on a project-by-project basis and has a relatively modest advertising budget, told K2 that he had "not thrown any horsepower" into assessing rebate language in contracts. The sources cited above further reported that major multinational advertisers tend to have more sophisticated clauses for capturing rebates than smaller brands. However, there is variation on this front as well. A U.S.-based former chief marketing officer at a global advertiser said that his agency contract required media costs to be passed through with no markups but did not specifically address rebates.

Even when contracts do address rebates, sources told K2 that it may be difficult for advertisers to determine what they are owed. K2 reviewed rebate-related clauses, current as of 2011, from advertiser-agency contracts for two large global advertisers; these clauses compel the AORs to pass on any cash discounts or rebates that are "directly and exclusively attributable" to the client's media investment. A media consultant who has reviewed this exact same rebate clause in other advertiser-agency contracts told K2: "The problem is: if you're a client, it's very hard to understand what you're owed as a direct result of your investment." The consultant said that a media supplier may negotiate a volume-based reward with an agency parent entity or an entity affiliated with a client's AOR, rather than the AOR itself. Therefore, the portion of that reward that is owed – i.e., directly and exclusively attributable – to the client may be difficult to calculate because rebates or discounts often flow from a pooled group of client ad spending.³¹

In addition, unlike the AOR, the agency affiliate or parent entity may have no contractual obligation to return or even disclose income earned from a client's media spend, according to the consultant. This view was corroborated by a former executive at an OOH agency owned by an Agency Holding Company, who indicated that his agency rarely contracted directly with advertisers, even though it purchased media for client campaigns and received rebates from media suppliers. He told K2 that his former agency was not privy to, nor necessarily bound by, whatever language the advertiser-agency contracts may have contained regarding rebates. "Were we bound by the same terms [as the AOR]? Maybe," he said. "What were our obligations to advertisers? We were subcontractors to contractors." He said that the agency's approach was to set aside funds in escrow and "pay back clients if we get caught."

A former executive at an agency within an Agency Holding Company also said that he observed colleagues striving to find ways to keep rebates that would otherwise pass through to clients. He indicated that they would exploit any perceived latitude within a contract's definition of a rebate, as if they were "playing a

³¹ The consultant added that many clients have struck out or amended the "directly and exclusively attributable" clause from agency contracts in recent years, and as a result it is less common than it used to be. However, the consultant also provided an example from 2016 of one Agency Group that, while pitching for a particular advertiser's global media business, red-lined rebate language that the consultant had included in a proposed advertiser-agency contract and replaced it with a clause limiting rebates to revenue "earned as a direct result" of the advertiser's investment.

game.” “Well, what is a rebate?” they would ask, according to the former executive. The answer would often be, “no, this is something else.” This maneuvering was aided by the fact that some client contracts on file were up to eight years old, the former executive told K2.³²

Another high-ranking former executive from a different agency within an Agency Holding Company, who left his agency approximately five years ago, described how his agency adopted a “defensive retreat” approach to transparency-related language within client master service agreements. The agency’s default position, he said, was to avoid including any transparency clauses at all. If the client insisted on some transparency, the agency wrote language that limited how much information it had to divulge, even in the event of an audit. “It became a game of words in how you described things,” he said. If the client persisted further and wanted language guaranteeing the full return of rebates as well as visibility into media costs, the agency’s fallback position was to rationalize how certain practices were “necessarily non-transparent” to clients, like its trading desk model or the way it buys inventory as a principal and assumes all of the risk. In such circumstances, the former executive said, the agency explained that the benefits from such practices were aggregated across multiple clients and could not be accounted for on a “one-to-one net basis.”

The same former agency executive added that analyzing client contracts for compliance became a standard agency practice “as the economics of client profitability became more problematic” and as client procurement departments increasingly “outfoxed” agencies during contract reviews with clauses that constrained their ability to make sustainable profit margins. He said that his agency evaluated contracts across several variables, such as payment terms and agency fee models, not just transparency.

4.2.5. Advertisers’ Awareness of Rebates

As noted in the Methodology section of this report, K2 was unable to trace the flow of funds – including rebate payments – between parties in individual cases without compromising the anonymity of individual sources and, therefore, did not do so. Investigative and/or auditing work such as this was beyond the scope of the study. Statements of the current and former agency employees who discussed knowledge of rebates are included above. In addition to these sources, K2 interviewed 22 advertisers who have managed U.S. media budgets.³³ None of these advertisers reported being aware of any rebates or other financial benefits flowing back to them from their media agencies.³⁴ However, all of the advertisers expressed the opinion that their agencies *should* pass through any rebates generated by their ad spend. Some told K2 of clauses in their contracts that stated as much; others were not aware of what their contracts said on the subject and conceded they had never explicitly asked their agencies about rebates. “We’ve been going on the assumption there are no AVBs in the U.S.,” said one global head of procurement for an international advertiser. “I’m not sure if we’ve ever forced it out of them [the agency] in writing.” The head of media for

³² Another former agency executive from a different Agency Group said clients often rely on expired master service agreements. Agencies have no incentive to alert clients that their contracts have expired, he said, because they fear this will invite a new pitch for business, which puts them at risk of losing the client’s business.

³³ As noted in the Methodology section of this report, K2 interviewed 29 advertisers from a range of industries. However, five of these advertisers were based in foreign countries and had no direct experience managing U.S. media budgets; one U.S.-based advertiser had experience managing a creative ad agency only; and another U.S.-based advertiser had no experience managing a media agency because his firm had brought advertising responsibilities in-house.

³⁴ This does not include discounted ad rates or other benefits that agencies may negotiate for clients, such as hosting free events or speaker engagements.

another global advertiser told K2 that his firm tracks rebates owed by its agencies in foreign markets, but not in the U.S. His “working assumption” is that the U.S. is a non-rebate market. This assumption, he told K2, is based on trust in his agency and his understanding of the international rebate market.

Five U.S.-based advertisers reported that representatives of their AORs had told them directly that they did not collect any rebates from media suppliers. One marketing and media director told K2 that he confronted his AOR regarding the allegations made by former Mediacom CEO Jon Mandel in March 2015 at the ANA Media Leadership Conference. According to the source, a representative of the AOR denied that it engaged in the practice of non-disclosed rebates: “This is just sour grapes by Jon Mandel. Trust us.” The source told K2 that he was unsure whether or not to believe him.

In other interviews, a director of media investment told K2 that he felt his company’s AOR, which was connected to an Agency Holding Company, was being honest when it claimed it did not collect rebates. However, he added that it was possible that a different entity within the holding company structure could be negotiating non-disclosed deals using his firm’s ad spend without his knowledge. In addition, a media manager at a large company speculated that possible rebate schemes or other hidden agency income could be handled through his agency’s finance department and that media planners and buyers working on his media account would simply not be informed.

When asked if his agency could be passing through rebates without him realizing it, the head of media for a U.S.-based advertiser was adamant that such activities would be indicated on agency invoices, which are examined closely by his team.³⁵ In contrast, a former media executive at another U.S.-based advertiser told K2 that it was indeed possible that his agency was returning rebates without him or his team knowing. “The number of transactions and invoices is breathtaking,” he said. “Given the complexities, it’s likely that they were returned and we were unaware.”

4.3. K2 Found Substantial Evidence of Potentially Problematic Agency Conduct Concealed By Principal Transactions

4.3.1. Overview

During the course of this study, K2 found substantial evidence that the lack of transparency inherent in principal transactions enables agencies to engage in potentially problematic conduct – i.e., conduct that may not be in the advertiser’s best interest. As described above in Section 4.1.3, many advertiser-agency contracts contain “opt-in” provisions that permit the agency to position itself as a principal in certain transactions. In a principal transaction, an entity within an Agency Holding Company essentially acts as a media supplier by purchasing media on its own behalf and then reselling it to the AOR at a markup. The Agency Holding Companies leverage the aggregate buying power of all of their clients – regardless of whether they opt-in to a non-disclosed buying model – to secure the highest possible discounts for media and, consequently, significantly higher margins on re-sale of such media to advertisers. When the AOR

³⁵ The source conceded, however, that he could only be certain that the agency was not collecting rebates if his company conducted agency audits across all media channels, which it does not do.

within the Agency Holding Company sells the media to an advertiser, the original purchase price – as well as other potentially relevant information – is not disclosed. These opt-in provisions also limit the advertiser’s right to audit the principal transactions.

According to information provided to K2, markups on media sold through principal transactions can range from approximately 30% to 90%. Sources also indicated that, as a result of these higher margins, media buyers are sometimes pressured and/or incentivized by their Agency Holding Companies to direct client spend to this media, regardless of whether such purchases are in the clients’ best interest. In addition, sources have stated that the agency may not disclose to the advertiser that premium media is unavailable through certain principal transactions.

Thirty-three (33) sources interviewed by K2 reported firsthand experience with principal deals that they deemed problematic. These sources provided detailed evidence – including relevant documents – regarding how principal transactions are structured and executed, as described in the sections that follow.

4.3.2. Agent vs. Principal Transactions

During the course of this study, K2 learned that, with regard to media buying, agencies typically act as agents in the U.S. market (i.e., they buy media on behalf of their clients, not for themselves). However, numerous sources reported that many contracts contain “opt-in” provisions that permit the agency to engage in certain principal transactions with advertisers. Generally, these principal transactions involve the advertiser agreeing to allow the AOR to utilize an affiliated entity within the holding company, such as an ATD, to supply media to the advertiser. Therefore, instead of the AOR directly purchasing the media on the advertiser’s behalf from an unrelated third-party media supplier, the ATD, or another holding company entity, purchases the media from a media supplier on its own behalf and then sells it to the AOR. Sources have informed K2 that, when an agency is engaged in a principal deal with an advertiser, the price the Agency Holding Company paid for the media, as well as potentially other relevant information, is not disclosed to the client.

4.3.2.1. Agent Transactions Defined

A typical agent relationship involves the AOR acquiring media directly from a media supplier. The AOR then bills the cost of the media plus its fee to the advertiser. This type of transaction is transparent in the sense that the AOR’s purchase price for the media is readily available to the advertiser. The diagram below illustrates the flow of a typical agent transaction.

Diagram C: Typical Agent Transaction

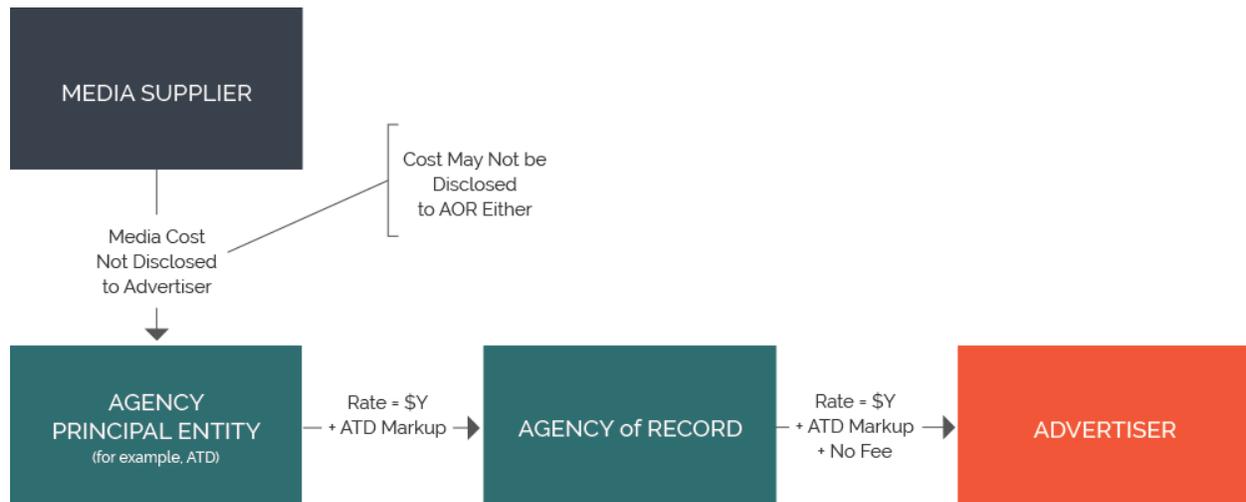


4.3.2.2. *Principal Transactions Defined*

In contrast to an agent transaction, a principal transaction involves an agency purchasing media on its own behalf – rather than on behalf of an advertiser – and then reselling that media at a higher price to its clients.

As described by multiple sources, one of the most common types of principal arrangement is one in which an affiliated entity within an Agency Holding Company structure (e.g., an ATD) acquires the media. The AOR then purchases the media from the ATD at a significant markup and sells the media to the advertiser at the AOR's cost and with a waiver of the typical agency fee. This type of principal transaction is not transparent in that the price the ATD pays for the media is not disclosed to the advertiser. Indeed, several sources indicated that the AOR is likely not informed of the price that the ATD paid for the media.³⁶ The diagram below illustrates the monetary flow of a typical principal transaction.

Diagram D: Typical Principal Transaction



According to multiple sources, there are two general methods by which agencies acquire the media used for principal transactions: (1) the agency pre-purchases the media (or enters into a deal to do so) and (2) the agency purchases the media programmatically. Each of these methods is discussed below.

4.3.3. *Media Purchased As A Principal*

A former C-level executive of an entity within an Agency Holding Company described the types of deals that agencies use to acquire media for principal deals as “closely held secrets” to which few people are privy. He further stated that the AOR likely does not even know the cost of media flowing through the other entities within the Agency Holdings Companies, including ATDs, barter companies, and other negotiating

³⁶ This model is hereinafter referred to as the “non-disclosed model.”

companies.

K2 interviewed multiple sources who were knowledgeable about some of the methods utilized by agencies to acquire media for principal deals. Specifically, sources described four distinct methods:

- (1) advance buys;
- (2) non-disclosed volume discounts;
- (3) dual rate cards; and
- (4) barter.

Each of these methods is described below.

4.3.3.1. *Advance Buys*

Multiple sources told K2 that agencies engage in “advance buys” of digital media – i.e., purchases in advance of an advertiser’s need for such media – in order to obtain discounts. Following an advance purchase, there is a window of time during which the purchased media must be used. Therefore, an agency theoretically runs the risk that it will realize a loss if it fails to resell the media within the specified time period. Sources reported, however, that agencies take specific steps to greatly minimize that risk. Relevant examples are provided below.

Examples of Advance Buys

Below is an example of how an agency used the aggregated buying power of its clients in an advance buy to extract an additional discount from the media supplier, thereby increasing both revenue and margins for the Agency Holding Company. This example was provided to K2 by a source who worked as an executive for multiple Agency Holding Companies. This former agency executive had firsthand involvement in advance buys, and his account was corroborated by two fully executed contracts that K2 was permitted to review but not maintain.

This particular transaction involved the simultaneous negotiation of two agreements, both between a principal entity within an Agency Holding Company and the same digital media supplier. The source explained that this method of negotiating both agreements together is a common practice used by Agency Holding Companies in order to leverage their aggregate buying power. The buying power of all of the Agency Holding Company’s clients – regardless of whether they opt into a non-disclosed buying model or not – is used to secure the highest possible discount for media that the Agency Holding Company purchases for itself. The existence of these agreements would not be visible to advertisers. In the interest of clarity, the parties to these agreements are referred to as ATD and media supplier, respectively.

Deal A: Advance Purchase of \$1,000,000 of Media

In the first contract reviewed by K2, the ATD agreed to immediately pay \$500,000³⁷ in exchange for \$1,000,000 worth of media.³⁸ The ATD was given one year to utilize the media purchased at this 50% discount.

The media purchased under Deal A was not for immediate use on an existing order and, therefore, the agency was technically at risk in that failure to sell the media within the required timeframe would result in a loss. However, the source explained that there was no true risk to the agency because the amount of media purchased in advance was considerably lower than the amount the agency had sold to clients in previous years and/or the media was already needed for media plans that had not yet been executed.³⁹ In light of these safeguards, the source characterized the risk to the agency as so highly mitigated that these deals should be considered advance buys with the advertisers' money.

For this particular deal, the advertisers who opted in received a discount of approximately 5% to 8% off the agency's negotiated rate for the media. To more easily understand the agency's margin under this deal, it is assumed by way of example that the agency's negotiated rate for media was \$100. The net effective rate for the discounted advance media the Agency Holding Company received would therefore be \$50.

The ATD would then mark this \$50 media up to somewhere between \$92 and \$95 before selling it to the AOR and, ultimately, the advertiser, for the same price. If the advertiser had purchased the media directly through the AOR, the cost of the media would have been \$100 plus the agency fee. Therefore, under this example, the advertiser saves 5% to 8% off the cost of media, plus the AOR's fee (which is waived). Although the ATD is providing a discount, the ATD is also realizing a far greater margin (90% with the "5% discount"; approximately 82% with the "8% discount") with media acquired through advance purchases, even without their normal fee (typically about 4%).⁴⁰

The former agency executive indicated that receiving a cash advance is also a significant advantage to media suppliers. The source explained that, although the media supplier may not be able to recognize the revenue until the media is actually sold, the cash is available to be used for staff, space, or investment, among other things. As such, this type of deal happens most often with smaller media suppliers. K2 was also informed by this source that media suppliers are told that if they do not agree to these deals, their competition will.

³⁷ According to the source, the media supplier cannot recognize the \$500,000 as revenue until the ATD 'purchases' the first \$500,000 of media. For the initial \$500,000 of media, the media supplier sends the ATD invoices for the media at the rate card cost, which the ATD does not pay, since they have paid upfront. For the \$500,000 in inventory, the media supplier submits invoices to the ATD with a cost of \$0.

³⁸ Again, this example is a description of an executed contract that K2 was permitted to review but not maintain. In addition to reviewing the actual agreement, the specifics of the agreement and the context were explained to us by an individual who is familiar with the deals.

³⁹ In addition, contracts typically include language specifying that the agency be named a priority creditor in the case of bankruptcy and, if the media supplier is sold and the Agency Holding Company disagrees with new leadership, contract terms specify that the agency can demand the money back.

⁴⁰ These percentages do not take into account an agency fee.

Deal B: Negotiated Discount for Agency Rate

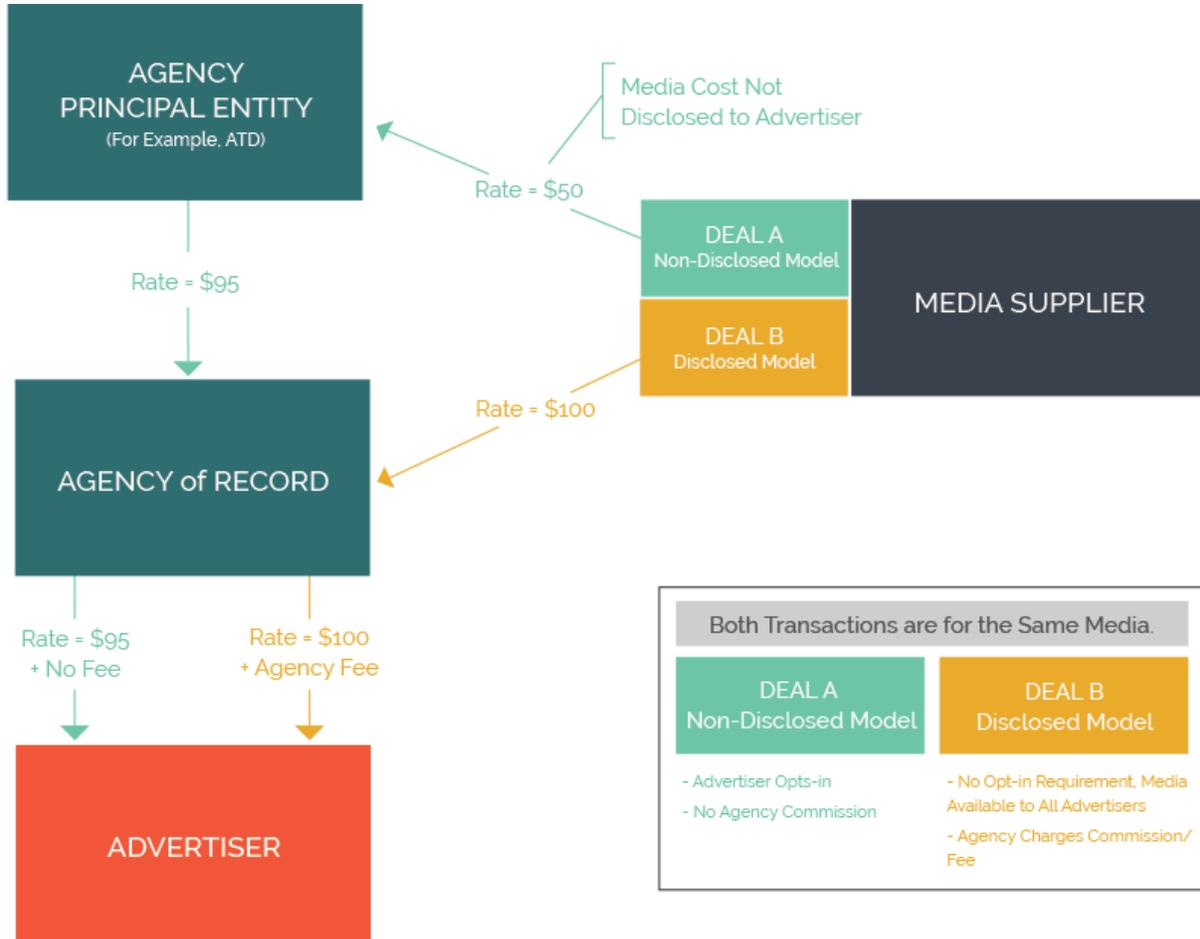
The second contract reviewed by K2 – Deal B – is an agreement for a tiered discount in return for a guaranteed level of spend. Specifically, Deal B required the agency to guarantee a spend of \$4 million in one year. In return, the agency was entitled to receive a discount of 2% on the first \$4 million in spend; once the \$4 million threshold was reached, any additional media purchases would be provided at a 4% discount. All agency clients were eligible to receive this discount regardless of whether they had “opted-in” to a non-disclosed model. This discount would be calculated off of the agency rate card, and, according to the source, the savings would be listed on an insertion order that would be accessible to the advertiser.

Under the terms of Deal B, the agency would be liable to return the discount in the event that the \$4 million threshold was not reached. According to the source, and as explained above, the agency greatly mitigates any risk because the guaranteed spend threshold is calculated based upon the amount of media the agency had sold to clients in previous years and/or what was already needed for media plans that had not yet been executed. In addition, the contract reviewed by K2 contained roll-over provisions that allowed the agency more time to meet the spending requirements. The source also indicated that it was unlikely that a media supplier would take legal action against an Agency Holding Company, even if the spending thresholds were not met during the extension period.

The source explained that the performance against these types of deals is closely managed. Specifically, the source indicated that there would be quarterly meetings, phone calls, and directives given from the holding company level to leads at the agencies to focus on moving spend to the media supplier in order to ensure that the contractual minimum volumes were reached.

In sum, Deals A and B are negotiated together in order to leverage the Agency Holding Company’s aggregate buying power to achieve higher discounts for advance buys. Essentially, by guaranteeing a relatively high-level of spend at the negotiated AOR rates, the Agency Holding Company is able to acquire a significant benefit for itself, which becomes non-disclosed revenue – namely, a 50% discount on media purchased in advance.

Diagram E: Deals A and B – Advance Buy and Discounted Media



Tables 1 and 2: Deal A and Deal B Comparison

Non-Disclosed Model – Deal A					
Discounted Cost to ATD	Agency Fee	Agency Markup	Cost to Advertiser	Agency Margin (%)	Agency Margin (\$)
\$50	-	90%	\$95	90%	\$45

Disclosed Model – Deal B					
Cost to AOR	Agency Fee	Agency Markup	Cost to Advertiser	Agency Margin (%)	Agency Margin (\$)
\$100	4%	-	\$104	4%	\$4

4.3.3.2. Non-Disclosed Volume Discounts

Another method by which agencies obtain media for principal transactions is through non-disclosed volume discounts. Similar to the volume discount described above (i.e., Deal B), the Agency Holding Company negotiates a deal with a media supplier for a discount based upon a guaranteed minimum spend. However, with these deals, the discount is not disclosed to the advertisers or, likely, the AOR.

Below is an example of a non-disclosed volume discount agreement that was provided to K2 by a source who worked as an executive for multiple Agency Holding Companies. This former agency executive, the same source who described Deals A and B above, also had firsthand involvement in non-disclosed volume discounts. His account was corroborated by two fully executed contracts that K2 was permitted to review but not maintain. This agreement involved a principal entity within an Agency Holding Company and a digital media supplier. For ease of discussion, the parties to the agreement are referred to as ATD and media supplier.

Under the terms of this contract, the ATD agreed to spend \$40 million with the media supplier over a two-year period; \$16 million of that spend was allocated to Year 1, while \$24 million was slotted for Year 2. The ATD would not be penalized for failing to meet the Year 1 requirement of \$16 million; any shortfall would be rolled into the Year 2 commitment. If the ATD exceeded the Year 1 target, the Year 2 spending target would remain unchanged. For example, if the ATD spent \$20 million with the media supplier in Year 1, it would still be required to spend \$24 million in Year 2. In exchange for this guaranteed spend, the ATD received a percentage discount off of the agency rate card. For purposes of this example, the discount is 20%.

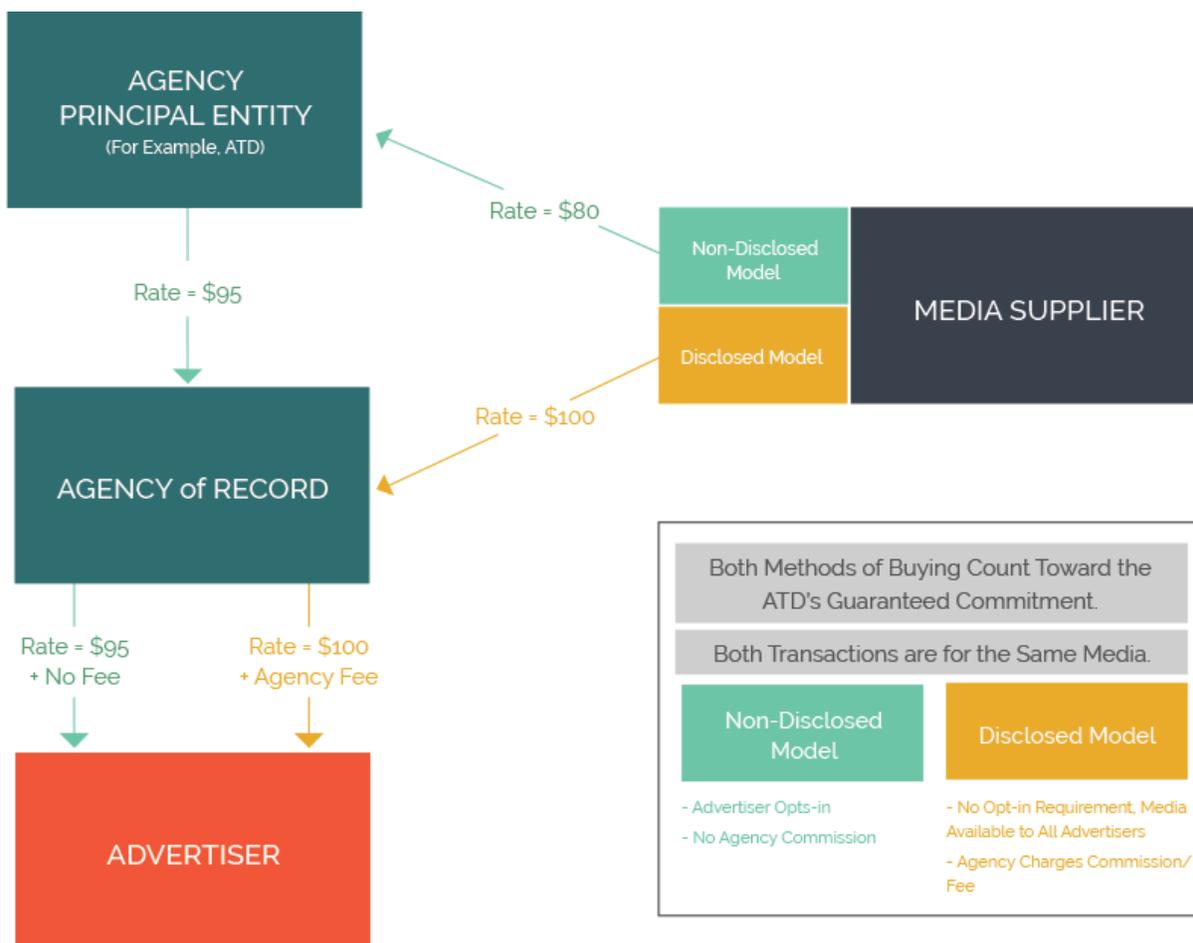
According to the source, this contract does not require the discount to be disclosed to either advertisers or the AOR. Similar to the other principal transactions described above, the ATD marks up the media before selling it to the AOR, which, in turn, sells the media to the advertiser. When the advertiser chooses to opt-in to use the media acquired by the ATD, the rate that it pays is ultimately lower than the rate it would have

paid by buying the same media directly through the AOR (i.e., as its agent). However, under the terms of the contract, even when the advertiser does not opt-in, the spend still counts toward the ATD's guaranteed minimum. This important factor demonstrates how the negotiated discount is, in fact, tied to the total aggregated buying power of its clients' spend.

The source also indicated that, generally, with these types of deals, the discounted media would typically not include the media supplier's best available inventory, as media suppliers attempt to include certain barriers in the contract designed to exclude their premium high-value inventory from the discount deal. Therefore, if an advertiser purchases media that stems from this type of deal, premium media may not be available, a fact which may not be disclosed to the advertiser. However, for purposes of the illustration below, it is assumed that the media purchased is of the same quality.

Diagram F: Non-Disclosed Volume Discount

The diagram below outlines the flow of a non-disclosed volume discount deal.



According to the same source, an agency's largest clients are called "whales" by both media suppliers and agencies. It is the buying power of these clients that Agency Holding Companies wield to secure discounts for all of their clients. K2's source stated that there has been a "huge disagreement" between agencies and media suppliers as to whether the spend of these clients should be included in this type of discount agreement. Many of these large clients have direct relationships with media suppliers and, as such, the media suppliers often take the position that they own these client relationships. The net effect may therefore be that many "whales," with a large amount of yearly spend at a particular media supplier, actually miss out on discounts because media suppliers have them excluded from the discount deals.

4.3.3.3. *Dual Rate Cards*

Another method for securing media for principal deals involves the negotiation and use of dual rate cards for the same media. In this method, Agency Holding Companies use the aggregate buying power of their clients to negotiate discounted rate cards for their principal entities, including ATDs. Essentially, an entity within the Agency Holding Company,⁴¹ but not the AOR, will negotiate with the media supplier for two rate cards: (1) an AOR rate and (2) a lower ATD rate. In contrast to the transactions described above, the dual rate card method involves the media being purchased on an as-needed basis based upon the established rate cards (i.e., there are no guaranteed spend requirements for the Agency Holding Company). Therefore, this method involves no risk to the Agency Holding Company.

The dual rate card method was explained to K2 by several different sources with direct knowledge of this practice, including an Agency Holding Company executive and multiple media suppliers. The method, as conveyed by these sources, is summarized below.

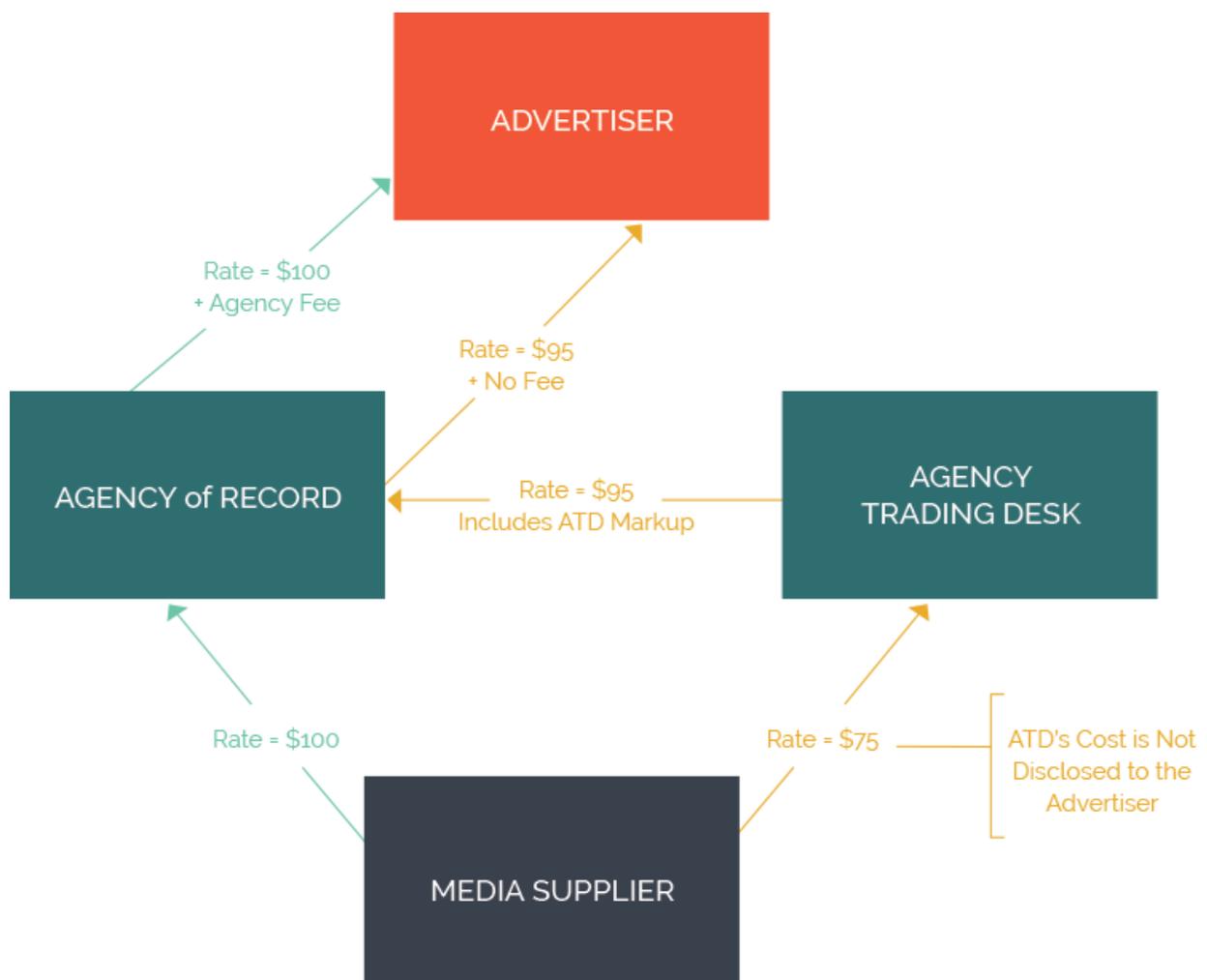
Using the leverage of its aggregate buying power, the Agency Holding Company is able to negotiate discounted rates. In this scenario, the lower rate negotiated by the Agency Holding Company is utilized for its principal entities, including the ATD. In contrast, the higher rate card is utilized by AORs to sell the media directly to advertisers in the capacity of an agent (as opposed to a principal).

If an advertiser chooses to utilize the ATD, the ATD marks up the media and sells it to the advertiser's AOR. The AOR then sells the media at its cost to the advertiser. According to these sources, neither the advertiser nor the AOR knows the price that the ATD paid for the media. The ATD sells the media at a rate that is less than the rate that would apply if the media were obtained directly from the AOR. Again, that is because the rate card negotiated for use by the AOR is higher than the rate card for the ATD.

⁴¹ For ease of describing this example, we will simply refer to the negotiating entity as the Agency Holding Company.

In the example diagrammed below, the AOR rate is \$100, while the ATD rate is \$75 for the same media from the same media supplier. Typically, the ATD will mark up the media to a point where there is still a savings to the advertiser. In this example, the cost of the media to the advertiser, if purchased through the ATD, is \$95. Had the advertiser purchased the media through the AOR, the cost would have been \$100 plus the agency fee. This, according to the sources described above, is by design. The price that the ATD paid for the media is unknown to both the advertiser and the AOR. The advertiser believes that it is getting a discount, but both rates – and the margins – are actually controlled by the Agency Holding Company, not the media supplier.

Diagram G: Dual Rate Card



Tables 3 and 4: Dual Rate Card Comparison

Non-Disclosed Model					
Discounted Cost to ATD	Agency Fee	Agency Markup	Cost to Advertiser	Agency Margin (%)	Agency Margin (\$)
\$75	-	26%	\$95	26%	\$20

Disclosed Model					
Cost to AOR	Agency Fee	Agency Markup	Cost to Advertiser	Agency Margin (%)	Agency Margin (\$)
\$100	4%	-	\$104	4%	\$4

In another example of a dual rate card agreement, a C-level executive for a media supplier informed K2 that his company already had an existing rate card with an Agency Holding Company for use by its AORs when the ATD sought a discounted rate card. The source said the discount that the ATD ultimately achieved through negotiations was approximately 20%. According to the source, the ATD rate card and the AOR rate card were part of the same deal; “It was all wrapped up together. It was very clear you couldn’t just have a[n] [AOR] deal and not have [the ATD] part of it.” The source explained to K2 that the agency network essentially leveraged the AORs’ aggregate spend in order to convince the media supplier to consent to the reduced rate card for the ATD.

4.3.3.4. *Barter*

According to sources, barter deals are highly complex and few people have an in-depth understanding of their operations. At a very high level, barter deals are trading arrangements that agencies can use to acquire media for principal deals. Some barter companies operate under the umbrella of an Agency Holding Company.

In some scenarios, advertisers work directly with barter companies to trade distressed or underutilized assets. A C-level executive of a barter company provided the following example of how an advertiser uses a barter company to acquire media for use in principal deals. In his example, which was based on an actual agreement, a manufacturer had developed new packaging and, as a result, had stockpiles of the old packaging in inventory. The barter company agreed to buy the outdated product at wholesale prices, which amounted to approximately \$2 million. In exchange, the advertiser agreed to purchase \$8 million worth of media through the barter company, a small fraction of the overall media budget of the advertiser. The barter company sold or traded the outdated product at a loss. However, the barter company acquired discounted media through other barter deals to fulfill the \$8 million spend for the advertiser to cover the losses and realize a profit. In the example provided, TV was the media that the barter company sold to the advertiser.

Barter companies also engage in less complicated advance buys of media. An executive from a media supplier explained that he is both approached by barter companies and seeks them out to engage in deals. Generally, if he is approached by a barter company, it is for a current media need for a particular advertiser, i.e., the barter company is already working with an advertiser on a barter deal and needs to acquire media to complete the deal. According to the sources, the media supplier takes “a bigger hit on its margin” when working with barter companies.

As an example, the source described a situation in which the media supplier would approach a barter company when the media supplier was falling short of its revenue targets. The media supplier entered into a deal with a barter company in which the barter company agreed to immediately buy a quantity of media, for example \$1 million worth, at full price. This allowed the media supplier to recognize the revenue in the current quarter. In exchange, the barter company received a substantially discounted rate with which to purchase a larger quantity of media, for example \$5 million, in the next quarter.

As discussed above in Section 4.1.3, an executive for a consulting firm, who was also a former high level executive within an Agency Holding Company, explained that, in approximately 2011, he and his colleagues noticed that agencies began inserting the term “inventory media”⁴² into contracts with advertisers. According to the source, after making inquiries, the source and his colleagues determined that inventory media was inserted to allow agencies to acquire “hugely discounted” media through barter.

4.3.4. Media Purchased Programmatically

4.3.4.1. Basics of Programmatic Transactions

An agency’s programmatic purchase of media for an advertiser is not a principal transaction per se. Indeed, there are agencies and companies that provide transparent programmatic buying options. However, according to numerous sources, many agencies treat programmatic buying as a principal transaction.

Buying media programmatically is a complex function that includes essential players and technology along the value chain. The inner workings of programmatic buying was explained to K2 by multiple sources, including former Agency Holding Company ATD employees and individuals from independent trading desks and ad tech companies. The programmatic sales discussed in this report involve a real-time bidding process in an open market. During these transactions, media is placed for sale, the media is purchased, and the ad is served in fractions of a second. Below is a simplified, high-level overview of programmatic transactions.⁴³

- Media suppliers provide media to a supply side platform (“SSP”) to be sold programmatically. Generally, at the media supplier’s request, a “floor” price can be set below which the media will not be sold. According to an ad tech executive with prior agency experience, the SSP will mark up the media approximately 10%.⁴⁴

⁴² As previously discussed in Section 4.1.3, a media consultant familiar with this term reported that, in his experience, inventory media generally refers to inventory that an Agency Holding Company buys as a principal.

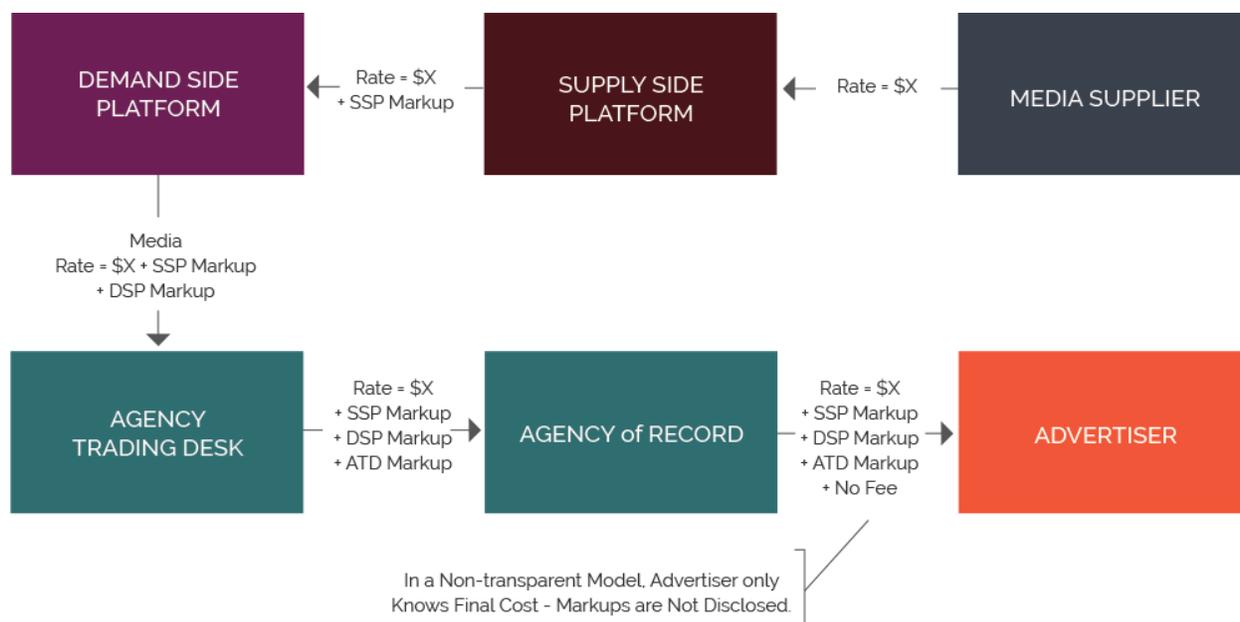
⁴³ There are other players and technologies involved in programmatic buying (e.g., ad servers). These have been intentionally omitted for ease of discussion in this section.

⁴⁴ An executive from an independent trading desk provided this estimate.

- The SSP then interacts with the demand side platform (“DSP”) to facilitate the bidding process. The DSP also provides the conduit for buyers to complete purchases. According to the executive cited above, the DSP will mark up the media approximately 10%. The buyer, for example, an ATD, will also mark up the media before re-selling. As mentioned above, many Agency Holding Companies treat these programmatic buys as non-transparent principal transactions and, therefore, do not disclose their markups to the advertiser.

Diagram H: Real-Time Programmatic Buying

K2 notes that the below diagram represents key participants in a programmatic buying transaction and is not intended to capture every intermediary entity involved in this process.

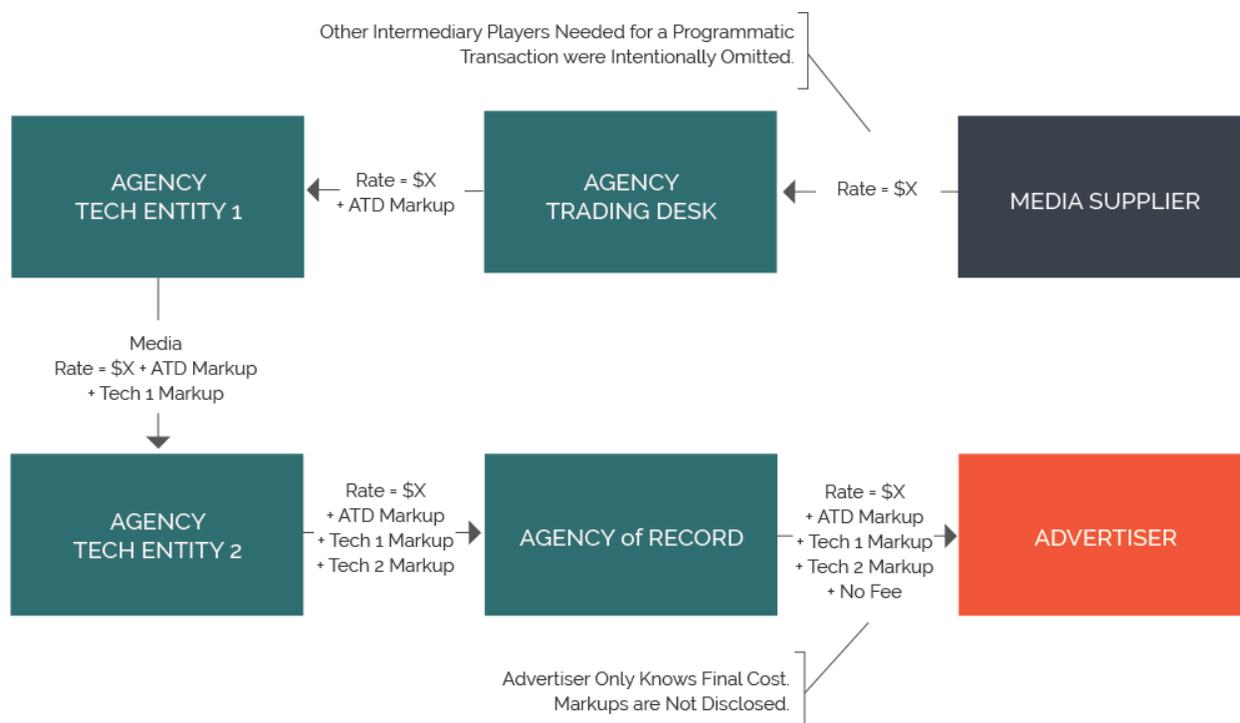


A source who recently held C-level positions at entities within two different Agency Holding Companies explained that non-disclosed “black box”⁴⁵ deals were originally designed to make it easier for media suppliers to sell media at a discount without creating unrealistic price expectations on the part of advertisers. According to the same source, however, increasing revenue pressure within the Agency Holding Companies led to a departure from this original purpose. Today, the source reported, Agency Holding Companies exploit the inherent anonymity of this method by taking large, non-disclosed markups on the media sold through black box transactions.

⁴⁵ The source used the term “black box” as a reference to non-transparent transactions where the agency’s cost of the media and the source of the media were not disclosed to the advertiser by the agency.

As an example, the source stated that the agency would use an ATD to acquire media, transfer the media to an affiliated technology entity within the Agency Holding Company, and then transfer it again to a different technology company within the Agency Holding Company, taking markups at each point.⁴⁶ The source stated that this activity could be demonstrated by tracking pixels or cookies on specific pieces of inventory.

Diagram I: Agency Holding Company Markup



Agency trading desks are not only used for programmatic real-time bidding in open markets but also as private marketplaces.⁴⁷ Through the private marketplace, agencies have the ability to automate the purchase of the media acquired through methods such as those described in Section 4.3.3 of this report.

A C-level executive of an ad tech firm stated that agencies use its software to load inventory into private marketplaces. According to the source, when the ad tech firm, which has visibility into these private marketplaces, finds the comparable inventory at a less expensive rate, it informs the agency. However, in the source's experience, the agency is never interested in using the media with the more favorable rates and continues to push spending with the particular media supplier identified by the agency. As a result of this, the source suspects that agencies are receiving incentives to utilize certain mid-tier media suppliers.

⁴⁶ In his example, the source provided the actual entities that would be involved within a specific Agency Holding Company.
⁴⁷ A private marketplace contains a pool of media that has been previously acquired by an Agency Holding Company through methods including those described in Section 4.3.3 of this report.

4.3.5. Lack of Transparency with ATDs

As discussed above, agencies utilize ATDs as a vehicle for non-transparent principal transactions. However, several sources indicated to K2 that it is unclear whether advertisers truly understand what they are opting into when they authorize their AORs to purchase media from ATDs in a non-disclosed model.

A high-level employee of a trade association stated that some advertisers do not understand how the “digital model” works, including programmatic buying; they may perceive that there is some wrongdoing when, in fact, the advertiser has explicitly opted-in to purchase space without the ability to see the underlying costs. The source further stated that the advertiser may not fully understand the terms of the contract to which it has agreed.

A former executive for multiple Agency Holding Companies explained to K2 that, “legally,” clients have to opt-in to non-disclosed deals. According to the former executive, with some advertisers, the marketing team may not be aware of the terms to which they are agreeing, mostly due to a lack of coordination. The source estimated that only about 50% of clients understand the philosophy behind the non-disclosed model. While these opt-in agreements say that a client recognizes that the Agency Holding Company is taking a risk and will take a margin, the source stated that advertisers do not have a good understanding of how much margin is taken.

This lack of transparency has caused some advertisers to take action. A high-level marketing employee of an advertiser informed K2 that his company attempted to audit the ATD affiliated with the advertiser’s AOR because of concerns regarding non-transparency. After the audit, the advertiser decided to build its own trading desk.

In contrast to the above, a former high-level employee of an ATD explained to K2 why he thought the ATD model could be beneficial to advertisers. The former employee described a “fixed buy” method that he believed was actually better for the advertiser than the traditional commission-based method of compensation. In his example, \$1 million would be provided as a flat fee to the ATD to meet certain metrics, including level of performance, for a particular advertising campaign. Assuming that the ATD was able to achieve those metrics for an amount less than \$1 million, the remainder would be the agency’s to keep. Conversely, the agency carries the risk that it may cost more to meet the predetermined metrics.

According to the former employee, the commission based method incentivizes the agency to spend money since it is being paid as a percentage of spend. The source stated that, with the commission model, “I have to spend more to make money.” Through the ATD fixed buy method, however, the source encountered situations in which spending less actually made more sense for the client. In essence, the ATD was able to achieve better results for less money. In these scenarios, the ATD would keep the difference and achieve a higher profit.

4.3.6. Perceived Advantages for Advertisers

Sources told K2 that principal deals were attractive to advertisers for two main reasons: (1) the cost of the media appears to be lower, and (2) there is no agency fee for principal deals. There is reason to doubt the validity of both perceived advantages.

4.3.6.1. *Lower Cost for Media*

As discussed in Section 4.3.3 above, the cost of media to an advertiser is generally less when purchased through a principal entity, such as an ATD, than if purchased through an AOR. However, it is important to note that the Agency Holding Company is only able to acquire the media at a significantly lower rate because it leverages the aggregate buying power of its clients through the methods listed above. It is also important to note that advertisers do not receive the full benefit of the negotiated discount. Moreover, the extent to which the ATD marks up the media is not visible to the advertiser because the model is non-transparent.

A former high-level executive within an Agency Holding Company provided an example of how non-transparency creates the opportunity for the ATD to make enormous margins on its media sales. The former executive stated that, when the ATD is utilized, clients do not learn the difference between what the ATD paid for inventory and what it charges the advertiser. The source stated “if a client says, ‘We’ll pay \$50 million in digital inventory,’ but we secure it for \$30 million, they don’t know.” The end result is that, with an ATD, the top line cost may be lower but the percentage of advertiser spend that goes to actual media purchases may be lower, too.

In addition, as discussed above, premium media may be excluded from some of these principal transactions, a fact that is not visible to advertisers. Therefore, with some transactions, the lower cost may not be for the same quality of media.

4.3.6.2. *No Agency Fee*

Since there is no agency fee for some media purchased through principal entities, advertisers believe that they are lowering their media-buying costs. Because there is no separate line item for the agency’s fee, principal deals give the appearance that more money is going directly to media spend. As described by a former Agency Holding Company executive, the greater the proportion of a client’s budget that is allocated to a non-disclosed model, the smaller the agency “fee” appears on a plan because it is actually “baked in” to the non-disclosed budget.

Despite the absence of an agency fee, Agency Holding Companies can achieve higher revenues and margins through principal transactions. A source who held high-level executive positions at multiple Agency Holding Companies stated that ATDs are the most profitable entities within the holding company. A former ATD executive told K2 that the margins for his ATD averaged approximately 30%, with some higher and some lower depending upon the situation.

4.3.7. *Internal Pressure to Direct Spend to the Agency’s Principal Entities and Investments*

According to multiple sources, higher margins have caused Agency Holding Companies to direct a greater percentage of clients’ spend to ATDs and other principal entities, a mandate with the potential to influence buying decisions made on behalf of clients. According to K2’s sources, multiple methods are being used to achieve this goal, all of which are described below.

4.3.7.1. *Internal Pressure and Specific Directives to AORs*

Multiple sources told K2 that Agency Holding Companies are pressuring and/or issuing directives to AORs to direct advertisers' spend to ATDs or preferred media suppliers. Below are some examples of this practice:

- As an example of an Agency Holding Company requiring that spend be directed to an ATD, K2 was provided with a copy of an email from an executive at an AOR to his team. In the email, sent within a month of the close of the fiscal year, the AOR executive stated that an Agency Holding Company executive had mandated that an additional \$6 million in spend be directed to the ATD by the end of the fiscal year due to lower than expected revenue.⁴⁸ The \$6 million redirection of spend was the total requirement for multiple agencies within the holding company.

The executive then directed the team to, within a few days, come up with a client-by-client plan to re-direct the required amount of spend to the ATD. This email clearly demonstrates that the primary reason for the agency redirecting clients' spend was the desire to achieve a higher profit for the Agency Holding Company. The email contains no mention of whether the redirection should be in the clients' best interest; nor is there any evidence to suggest that any factor other than agency profit was considered in making this decision.

- Another former executive at an Agency Holding Company who left within the last two years stated broadly that the goal of the Agency Holding Companies is to direct at least 50% of digital business through affiliated entities, such as ATDs, to facilitate this markup.
- A former C-level executive for an OOH agency within an Agency Holding Company said his management would pressure planners and buyers to increase spending with media suppliers who had agreed to revenue-generating practices that were not transparent to clients (e.g., markups on inventory that the agency bought as a principal). "Was [Agency]⁴⁹ channeling business to certain vendors regardless of the best interests of the media plan? Absolutely," he said. The source added that his agency, as a matter of practice, would only inform clients about such practices if it felt the advertiser-agency contract required it. "Otherwise, we didn't tell the client," he said.

⁴⁸ Some of the details and actual amounts from the email have been changed to protect the source of the email. However, the substance of directing spend to an affiliated entity within the Agency Holding Company to achieve higher margins is true to the original email that K2 reviewed.

⁴⁹ This agency name has been redacted.

- A high-level sales director for a media supplier informed K2 that there had been occasions in mid-2015 when he had reached a verbal agreement with a buyer from an agency but was later “kicked off the plan” because the agency’s barter company had insisted on using a preferred partner. The source heard directly about one occasion in which an executive at the agency’s barter company in charge of vendor contracts scolded one of the buyers within the agency for putting the source’s company on the media plan for a spend worth a few hundred thousand dollars. The barter company executive said that there was no incentive for the agency to use the source’s media company. According to the source, the buyer was told by the barter company executive, “Frankly, it’s hurting our bottom line, so stop doing it.” The source told K2 that, after his company was removed from media plans, he received a text from someone he knew at the agency that stated, in substance, “Hey man, I’m really sorry, but this is over my head.”
- A former head of U.S. digital investment for an agency described how, approximately six years ago, senior management within his agency’s corporate parent, an Agency Holding Company, issued a mandate that any digital programmatic media trading above a certain dollar threshold must be directed to the Agency Holding Company’s ATD rather than to any third-party ad networks. “The mandate ultimately went away after six months and it became more of a strongly-encouraged suggestion that buys should go through [the trading desk],” the source told K2. He said that, around the time of this directive, his agency added a clause to advertiser-agency contracts that relieved the agency of any obligation to disclose to clients how much the trading desk earned in fees from these programmatic trades.
- A former executive at an ATD who left approximately seven years ago said that it was “strongly preferred” by the Agency Holding Company that agencies within the group used centralized services such as the in-house trading desk, which he said skewed investment decisions to benefit the corporate parent rather than clients. “You had a centralized function of digital media-buying that is effectively forced upon various line agencies in the company,” he said. “It’s not inherently a bad thing but it does inflict compromise on the objectivity of agencies for the benefit of the corporate center rather than the clients they serve.” The source added that the centralized trading desk “was set up as an option, but the way it went to market and the way it was managed was far more heavy-handed than that.” He said there was an expectation that client money would be spent using the in-house trading desk rather than third-party entities.
- Another former C-level agency executive told K2 that about one quarter of all the agency’s digital trading was funneled through the Agency Holding Company’s ATD as a result of pressure that his agency’s Board applied to management. The source said that agencies within the Agency Group had some autonomy to say “no” but that the level of autonomy declined during his tenure, which ended about five years ago.
- A former managing director of a U.S. agency’s programmatic trading who left within the last two years reported that the chief digital investment officer for the agency’s corporate parent, an Agency Holding Company, would pressure each of the agencies it oversaw to direct client spending toward companies in which the corporate parent had invested. “The more money we pipe into what we own is better for us in the long run,” the source said he was told.

4.3.7.2. Incentives for Agencies to Direct Spend to the ATD

Multiple sources told K2 that Agency Holding Companies provide financial incentives for their agencies to direct spend to ATDs.

As an example of these incentives, K2 was informed by a former Agency Holding Company executive that the ATD paid an internal rebate to agencies equal to 15 cents for every dollar directed to the ATD. This rebate was discussed at senior-level meetings. In addition, an agency within the same Agency Holding Company also offered bonuses to buyers and planners who pushed client spending to the ATD.

Another example was provided by an ad tech source who informed K2 about a conversation he had with a senior executive at an agency at a different Agency Holding Company. K2's source indicated that the agency executive explained that senior buyers were given cash bonuses tied to the volume of business directed to the ATD.

A former holding company executive, who left the industry within the last two years, told K2 that some Agency Holding Companies are known to offer certain financial incentives for high level employees (typically group director or above) to encourage them to direct money through internal entities. He stated that these incentives took the form of quarterly bonuses in which employees could potentially "get a \$5,000 check every quarter." He noted that these arrangements were not frequent because the people selected had to "understand the importance of supporting an agency" and had to "stay quiet" about the arrangements. This executive also told K2 that, at his former holding company, he was one of a group of under a dozen people who knew the details of the holding company's rebate and principal buying deals with media suppliers. He emphasized that this information was negotiated at a high level and kept confidential.

A former agency executive described a variation of the internal incentive model involving agency staffing levels. In this example, the agency provides internal incentives to direct spend to an ATD for the purpose of increasing the amount of staff available on an account. According to this source, senior executives will often agree to prohibitively low percentage fees in order to win business and then subsequently impose extremely low staffing levels on the project team. When this occurs, the project team charged with actually executing the media plan will push the advertiser to utilize principal entities such as ATDs. There are two reasons for this. First, by directing spend to the ATD, the project team can off-load some of the work from their over-extended team to the ATD team. Second, directing spend to the ATD will allow the Agency Holding Company to make increased margins on media. This, in turn, provides the project team with leverage to get more staff assigned to the account.

4.3.8. Other Non-Disclosed Agency Markups and Fees

Below are some examples of other non-disclosed markups that agencies use to increase profitability:

- A source stated that agencies can markup media at the demand side platform ("DSP") level, applying a flat markup to every bid. Theoretically, clients can gain access to this data showing the purchase price and markup, which is noted in the media plan entry. The source, who held high-level executive positions at multiple Agency Holding Companies, stated that the trading function

obscures the relationship further. Many agencies are taking a markup on digital media and then making a commission on top of that, which the source described as “double-dipping.”

- An example of a markup at the DSP level was provided to K2 by an advertiser. A senior marketing executive at a global advertiser stated that, in January 2015, a marketing employee of one of the advertiser’s brands came to him with an invoice from a DSP to the advertiser’s agency. This marketing employee was provided with the invoice by someone he knew at the DSP, which was contracted through the advertiser’s agency to work on the advertiser’s brand. The invoice provided by the DSP employee reflected a substantially lower price than the price that was ultimately charged to the advertiser’s brand; i.e., the agency had marked up the amount on the DSP invoice. K2’s source, the senior marketing executive, called his contact at the agency, who effectively admitted that the agency had inappropriately applied a markup and made a “gentlemen’s agreement” not to do it again.
- Another example was explained to K2 by a C-level executive of a technology company that provides software to agencies. According to the source, his company has direct insight into the agency practice of loading fees onto media budgets in a bid to capture set revenue margins. The source stated that ATDs were created to recapture margin and that agency employees are “under such pressure to hit margin numbers; in some cases, 30% of the budget goes to fees.”

The source further stated that reports that agencies send to clients do not include the percentage of technology fees and technology maintenance fees that agencies layer onto the final invoice. The source’s company sees the addition of fees “whenever the agency has to capture a certain margin.” According to the source, trading desks are mandated by their holding companies to generate a margin as high as 30% or 50%.

- The source also told K2 about an additional method whereby agencies still charge a fee if an ad was not appropriately delivered. The source stated that he has access to data that demonstrates that, after a buy is consummated, anywhere between 3% and 30% of impressions are unused or discrepant (as a result of ad bots and the like). However, the agencies still charge advertisers for this inventory by calculating their fee based upon the assumption that these ads were appropriately served. In other words, clients are still paying a fee for media as if it were delivered when, in fact, it was not. The ATD, however, receives reimbursement from the media suppliers for ads that were not appropriately served.

The source said that, as a result of the frequency with which ads are not appropriately served, agency-advertiser contracts increasingly include provisions specifying that a 10% to 15% discrepancy is acceptable in programmatic buying. According to the source, however, many advertisers still do not realize that they can actually find out the exact percentage or number of ads that were not properly delivered and then ensure that they are not charged. The source stated that “there is not one agency we’re dealing with that’s providing the true numbers back to their clients.”

- Sources also told K2 that agencies are marking up items that are not strictly media, for example, ad serving. A former C-level executive of a digital entity within an Agency Holding Company estimated that his Agency Holding Company marked-up ad servers 200% to 250%. This source

stated that this markup is not disclosed to clients. The source attributed the ability for agencies to effectuate these types of markups to advertisers' naiveté and further stated that advertisers generally do not ask the right questions.

- K2 identified evidence of one Agency Holding Company charging media suppliers a fee in excess of 10% in order to place media with its affiliated agencies. A media supplier executive related to K2 a practice by this Agency Holding Company that he stated was essentially a rebate described as a payment for a service. In addition to explaining how this practice worked, the source provided K2 with a redacted copy of the agreement between the media supplier and the company within the Agency Holding Company that owns the media transaction platform described below. For ease of discussion, this entity within the Agency Holding Company will be referred to as an ATD.

The source explained that, in order for the media supplier to sell its media programmatically, the media supplier was required to use the ATD's media transaction platform. The ATD charged media suppliers approximately 10% of the cost of the media for this service. The source told K2 that the platform's purpose was primarily to process insertion orders, which he described as "just paper moving from one entity to another." He stated that in his opinion, this practice was a way for the Agency Holding Company to disguise the payment of rebates. The source stated that although the platform "technically" provided a service, the agency "said it would be more efficient for us, but it's not."

Rather than the media supplier paying the 10% as a fee, according to the contract, the ATD owed the media supplier a "Royalty fee" of approximately 90% of the "Advertising Sales Revenue." The source stated, "They phrased it as a royalty fee rather than a rebate, but it's [approximately 10%] that's vaporizing from working media."

4.4. K2 Found Evidence of Non-Transparent Business Practices in the U.S. Market Arising from Agencies Holding or Soliciting Equity Stakes in Media Suppliers

4.4.1. Transparency Issues with Equity Investments

A former senior holding company executive noted that equity investments by agencies or holding companies in media companies "make a lot of people nervous," due to a perceived move away from the "separation of church and state [between agency and media company]." The former executive stated that if agencies "pick right" in investments and choose the companies with the best product, pushing spend to that company can "help everyone." Problems arise, he stated, when holding companies push business toward a company that is "not working for [a] particular client."

Several former senior level agency employees reported that they felt pressure from the senior executive level of Agency Groups or Agency Holding Companies to direct spend to companies in which the agency or holding company held an equity investment. Additionally, a former executive of an ad tech firm reported that his firm had entered into a "preferred partner" agreement with an Agency Group which included the Agency Group receiving an equity stake in the tech company as well as lower rates. The former ad tech

executive stated that, as a result of this deal, the Agency Group created a “massive preference” for the ad tech company among its clientele. He described this as an “awkward relationship” in which a media planner made decisions ostensibly for the benefit of its clients but, in reality, would push client spend to the ad tech company in order to take advantage of its lower rates, which were more profitable for the Agency Group.

An executive at a technology company in which an Agency Holding Company holds a minority equity stake reported that, following the equity investment, his company lost business from its investor’s competitors. The former holding company executive echoed this, stating that, in his experience, if/when an investment becomes known or is announced, other agencies may decrease the business they provide to that company so as not to be contributing to the profits of a competitor. Investing through warrants is seen as less risky, he said, since it does not need to be disclosed in the same way as straight equity; it is also less likely to attract scrutiny for both the holding company and the media supplier. The former executive said that equity positions are generally listed in holding company earnings, while warrants are not required to be disclosed in the same way.

A former agency executive who worked directly on these investment deals described the strategy of pushing these services internally “as any company would approach trying to cross-sell any owned asset.” This executive stated that the assumption was that the companies in which the agency chose to invest were “best in class” products. He stated that, if a company his former holding company owned was proposed for a media plan, clients would be informed. When questioned about the procedure for that, he stated that he was not positive that the communication was always carried out down the line, and conceded that it was possible that some clients were not aware. The former executive stated that the “operating procedure around those investments has been disclosure,” but noted that the holding companies are “big, scaled organizations” and there “have definitely been” communications that omitted mentioning an investment.

4.4.2. Contingent Equity as Rebate

In addition to cash and free inventory, three individuals mentioned in their interviews that they had heard of rebate deals involving contingent equity, in the form of stock warrants, as the financial benefit (none of the individuals interviewed for this study reported having been personally involved in a deal of this nature). Two of these accounts are summarized below (the third reported hearing of this practice generally but did not provide a specific example):

- An individual who holds personal investments in several companies in the ad tech space reported that one of the companies in which he is invested was approached several years ago by a large holding company, which offered to direct more business to it in exchange for equity or stock options. The investor stated that he was not directly involved in the conversations but reported that he believed the proposed deal was structured with contingent equity rather than stock because there were fewer reporting requirements for public companies holding a contingent equity stake in another company. The deal was ultimately not consummated.
- The CEO of a large ad tech company reported to K2 that he had received requests from representatives from several large holding companies, primarily during the late 2000s, offering to provide “access” at their holding companies in return for stock warrants. The executive interpreted the offer of “access” to mean that he would receive more business.

The executive provided accounts of two meetings in which these deals were proposed. He stated that, during one of these meetings, an executive of a holding company investment entity implied, “If you don’t offer warrants, you don’t get business.” During the other meeting, an executive at a holding company trading desk told the ad tech executive, in substance, that “I’d love to help you make connections ... How we structure this is, we give you access and you give us [warrants].”

The executive claimed that his company initially declined these deals, but eventually did enter into a “strategic partnership” with an Agency Holding Company that involved providing the holding company with stock warrants; the holding company later made a larger equity investment that was publicly announced.

5. Several Factors May Be Enabling and/or Contributing to the Proliferation of Non-Transparent Business Practices in the U.S. Market

The sources interviewed by K2 expressed a diversity of opinions regarding the factors that most directly contribute to the proliferation of the non-transparent business practices described in the previous sections of this report. The most frequently cited of these factors are discussed below.⁵⁰

5.1. Client Pricing Pressure

During the course of interviews, over 20 sources⁵¹ independently cited advertisers' efforts to drive down agency fees as a reason why agencies are seeking additional sources of revenue beyond commissions. A representative sample of these comments is provided below:

- A former Agency Holding Company executive who left the industry within the last two years reported that, approximately ten years ago, client media pitches were led with discussions about campaign strategy and an agency's ideas. He reported that this dynamic has now shifted to one in which discussions about price take the lead. He noted that "many" clients entering into pitches currently send out large spreadsheets asking agencies to produce detailed pricing information in advance of a presentation on strategy. He describes this practice as a "buying model, not a thinking model."
- A former agency executive who currently serves as an industry consultant discussed the same dynamic. He suggested that the trend coincided with the financial crisis in the late 2000s and stated that the role of procurement in media buying increased after the recession and contributed to the idea of media as a "cost to be managed downwards" rather than an "investment in growth."
- Several former agency executives reported that client-driven extended payment terms were a stress factor for agencies' cash flow. One former agency executive cited a large global advertiser who reportedly demanded a payment period of 150 days. He identified this as an example of clients asking agencies to "effectively ... bankroll them." Another former agency executive recalled an RFP from a large global advertiser that specified that agencies had to agree upfront to extended payment terms in order to even be considered for the client's work.
- A marketing executive at a print and digital media supplier similarly reported that he was aware of media pitches during the last year in which clients demanded upfront that agencies agree to deliver a 10% cost savings in order to be considered for the work.
- A current ad tech executive said that, in his opinion, the current generation of advertisers has been taught that "to work with ad agencies is to get them to do more with less each year." This, in turn, has encouraged agencies to focus on devising profit-making products in addition to client billings.

⁵⁰ K2 notes that these topics were not covered with each person interviewed; the content of each interview varied based upon each individual's experience and subject matter expertise.

⁵¹ The majority consisted of current and former agency and Agency Holding Company employees.

The executive said agencies “end up committing to business models where, from the outset, they can’t actually make money, and that creates further pressure on them to pursue products behind the scenes that help them make money.” He said that clients have “put their agencies in an untenable position.”

- A marketing executive at a major global advertiser reported that he was aware that agencies “blame clients for squeezing them on payments and extending payment terms ... But,” he argued, “that is separate to the need to find a better model for transparency.”

5.2. Increasing Complexity of the Media-Buying Landscape

Approximately a dozen sources interviewed by K2 provided substantive comments on the increasing complexity of the media-buying landscape and the corresponding struggle by advertisers to respond to these rapid changes. A sampling of these comments is provided below:

- A marketing executive at a large global advertiser, who formerly served as an agency executive, told K2 that there were few other advertisers like him with professional subject matter expertise. “There are many clients who are naïve of how agencies manage their media spends,” he said.
- Another marketing executive at a multi-national advertiser reported that he had attempted to build a provision into his agency contract that prohibited the agency’s trading desk from taking a markup on media. He reported that the provision was ultimately left out of the contract by executives at the company who did not understand programmatic buying and, therefore, why the provision was important.
- A former agency executive who currently serves as a media consultant reported that, in his experience, the ability and skill level of advertisers ranged dramatically and depended in large part on the composition of the staff. Those advertisers that hire former agency executives and thought leaders are better informed. Others suffered from a “lack of ecosystem knowledge,” he said.
- Another former agency executive told K2 that, in his experience, some clients did not understand what digital media should cost and how it should be priced. As an example, he recalled an instance in which an advertiser’s head of marketing said that he calculated a CPM for digital spend by using the CPM he had for direct mail buying.
- An executive at a large print and digital media supplier asserted that, in recent years, media buying has become vastly more complicated, with less of a linear relationship between spend and results (i.e., more spend does not necessarily lead to better results). In this environment, advertisers are less sure of how and where to spend their money in order to drive sales. He described this as having more potential “dials” to turn.

This executive further stated that he believed that this complexity contributed to a complacency among certain advertisers. In his opinion, clients who did not fully understand the market and their agency’s buying strategy were reluctant to question results they received from their agencies if the agencies were meeting their financial targets.

He stated that advertisers’ procurement departments typically looked at an aggregate CPM from

an agency and did not “go down to the nitty gritty.” He stated that he believed that there might be a tendency for clients to look for things to make them feel “more confident, not less confident,” in order to avoid creating the added burden of “digging into what went into meeting a CPM.”

- An industry trade association executive reported to K2 his belief that advertisers lack and do not prioritize subject matter expertise in media buying. He asserted that many advertisers who lack in-house technical subject matter expertise report that they do not trust their agencies, but rely upon them entirely to handle the technology and strategy upon which their campaigns are built.

5.3. Limitations On Audit Rights

During interviews, advertisers offered varying accounts of the nature and extent of their audit rights under their advertiser-agency contracts. Some advertisers reported regularly commissioning media performance and financial audits; some said that their contracts only permitted them to audit their AOR and not any affiliated companies within the Agency Holding Company; some professed a complete lack of awareness of their audit rights. Examples of these variations are included below:

- A former head of global media for an international advertiser said that he helped negotiate broad audit rights with the firm’s agencies that extended up to the holding company level and included any affiliate organizations of the Agency Holding Company. “We had the right to audit the books of every affiliated organization in every country for all our agencies,” he told K2. However, in his experience, the firm only commissioned audits on Agency Group operations at a country level, never on the agency’s global holding company. He recalled one occasion when his firm sought to activate its full audits rights but the agency “flatly refused to allow us anywhere near the holding company-level accounts or numbers, so technically they were in breach of contract.” The source said his firm considered taking legal action but decided against it because it feared a lawsuit could damage its continuing working relationship with the agency. The source, who has former agency experience, added that even if his firm were to obtain full audit access in order to uncover any non-disclosed sources of agency revenue, “it would be an enormous task to unpick the various stitches in the tapestry to find out where the gold is buried.”
- Another advertiser who dealt with a different media agency claimed that his former company enjoyed audit rights ranging up to the global holding company, although he was not sure if the company ever pursued such a high-level audit.
- A media consultant told K2 of an advertiser that had a media services agreement with an agency within an Agency Holding Company that allowed that agency to take a margin on television airtime as long as the overall cost was consistent with “market rates.” The media consultant asked the client about this clause and was informed: “The agency told us they have to have this language in all their contracts, but they said they’re not adding these margins with us.” The consultant told K2 that the client’s audit rights extended only to the agency’s monthly planning fee and not its media purchases; therefore, the client had no ability to verify this claim by way of auditing.

6. Conclusion: Within the Sample Studied by K2, Non-Transparent Business Practices Were Found to Be Pervasive

As described in the preceding sections, K2 found substantial evidence of non-transparent business practices in the U.S. media-buying marketplace. These practices include the following:

- Rebates in the form of cash, free space or equity, which may be structured as a payment for services;
- Principal transactions in which Agency Holding Companies leverage the aggregate buying power of all of their clients – regardless of whether they opt-in to a non-disclosed buying model – to secure the highest possible discounts for media and, consequently, significantly higher margins on re-sale of such media to advertisers;
- Certain potentially problematic practices, enabled by principal transactions, including Agency Holding Companies pressuring, directing, and/or incentivizing media buyers to direct client spend to higher margin media, regardless of whether such purchases are in the clients' best interest; and
- Agency Holding Companies taking equity stakes in media suppliers and, thereby, creating conflicts of interest.

According to the sources interviewed by K2, several factors may be contributing to the proliferation of these non-transparent business practices. Such factors include the following:

- Advertisers and their procurement departments drive down agency fees and seek extended payment terms, thereby causing agencies to seek additional sources of revenue;
- Advertisers are struggling to respond to rapid changes in the media-buying landscape and may lack the subject matter expertise to properly assess their media plans and/or include contractual provisions that protect their interests; and
- Some advertisers have limited audit rights that are insufficient to detect the kinds of non-transparent business practices described above, do not fully exercise their audit rights, and/or are not aware of what audit rights their agency contracts permit.

Within the pool of sources studied by K2, non-transparent business practices were found to be pervasive, in the sense that evidence of their existence was widespread throughout the sample. This conclusion is based upon the following key quantitative and qualitative factors:

As noted in the Methodology section above, 136 of the sources K2 interviewed were focused on the U.S. market, 117 of whom were directly involved in the media buying process. Of these 117 individuals, 59 reported direct experience with non-transparent business practices, including rebates (34 sources) and principal deals that enabled potentially problematic agency practices (33 sources). Some of these sources reported multiple experiences with separate and unrelated non-transparent business practices (e.g., the same source reporting both rebates and problematic principal transactions).⁵²

Non-transparent business practices were not limited to a specific type of agency. K2 found substantial evidence of non-transparent business practices in Agency Holding Companies, as well as in certain independent agencies. Evidence included both detailed source accounts and significant documentary evidence.

Non-transparent business practices were not limited to one specific type of media. K2 found evidence of non-transparent business practices across digital, OOH, print, and television media.

There were also systemic elements to some of the non-transparent business practices reported to and examined by K2. Specifically, K2 found evidence that senior executives at agencies and Agency Holding Companies were aware of and even mandated some non-transparent business practices, suggesting high-level buy-in at these companies. K2 also found evidence that contracts for rebates and other non-transparent business practices were negotiated and sometimes signed by agency executives, suggesting that these practices were part of the regular course of business. Examples occurring within the last five years – and discussed in previous sections of this report – are summarized below:

- As discussed in Section 4.3.7, a former holding company executive reported that some Agency Holding Companies are known to offer certain financial incentives for high level employees (typically group director or above) to encourage them to direct money through internal entities. These incentives took the form of quarterly bonuses in which employees could potentially “get a \$5,000 check every quarter.” This executive also told K2 that, at his former holding company, the details of the company’s rebate and principal buying deals were negotiated and closely held by a small group of high-level executives.
- As discussed in Section 4.3.7, a former managing director in charge of a U.S. agency’s programmatic trading reported that the chief digital investment officer for the agency’s corporate parent, an Agency Holding Company, would pressure each of the agencies it oversaw to direct client spend toward companies in which the corporate parent had invested.
- As discussed in Section 4.3.7, a former C-level executive of an OOH agency within a larger Agency Holding Company said his management would pressure planners and buyers to increase spending with media suppliers who had agreed to revenue-generating practices that were not transparent to clients (e.g., markups on inventory that the agency bought as a principal). The former executive indicated that spend was channeled to certain vendors regardless of whether the purchase was in the best interest of the client; moreover, clients were only informed of such practices if the advertiser-agency contract specifically required it.
- Four individuals interviewed by K2 also reported entering into rebate or service agreements with

⁵² This overlap accounts for why the total of 59 sources who reported non-transparent business practices is less than the sum of those reporting rebates (34) and principal transactions that enable potentially problematic agency practices (33).

agencies that were negotiated or signed by senior executives at agencies or Agency Groups within the last four years. Additionally, an executive of an ad tech company operating in non-U.S. markets reported that a U.S.-based trading director of an Agency Group negotiated both rebate and service agreements deals with the ad tech company. These agreements are discussed in further detail in Section 4.2.3.

In addition to the more recent examples cited above, K2's sources identified similar examples that occurred between five and ten years ago, suggesting that these practices – and the high-level executive support they receive – are not new:

- As discussed in Section 4.3.7, a former head of U.S. digital investment for an agency described how, approximately six years ago, senior management within his agency's corporate parent, an Agency Holding Company, issued a mandate that any digital programmatic media trading above a certain dollar threshold must be directed to the Agency Holding Company's ATD rather than to any third-party ad networks.
- As discussed in Section 4.3.7, a former managing director at an Agency Group's digital ventures unit who left approximately seven years ago said that it was "strongly preferred" by the Agency Holding Company that agencies within the group use centralized services such as the in-house trading desk, which he said skewed investment decisions to benefit the corporate parent rather than clients.
- As discussed in Section 4.3.7, a former C-level agency executive reported that about one quarter of all the agency's digital trading was funneled through the Agency Holding Company's ATD as a result of pressure that his agency's Board of Directors applied to management.
- As discussed in Section 4.3.7, the head of an independent agency told K2 about a meeting he had approximately ten years ago with an Agency Group. During the meeting, a senior executive at the Agency Group told the source about various ways one of its agencies was making "grey revenue" from U.S. media spending, including not returning media rebates to clients and keeping payments for unbilled media (i.e., moneys received from clients for which they have not received an invoice from the media supplier), after placing them in escrow for a period of time.

In sum, non-transparent business practices, in numerous problematic variants, were found throughout the sample examined by K2. The pervasiveness of these practices in the sample strongly suggests that non-transparent business practices are also common in the media-buying ecosystem from which the sample was drawn.

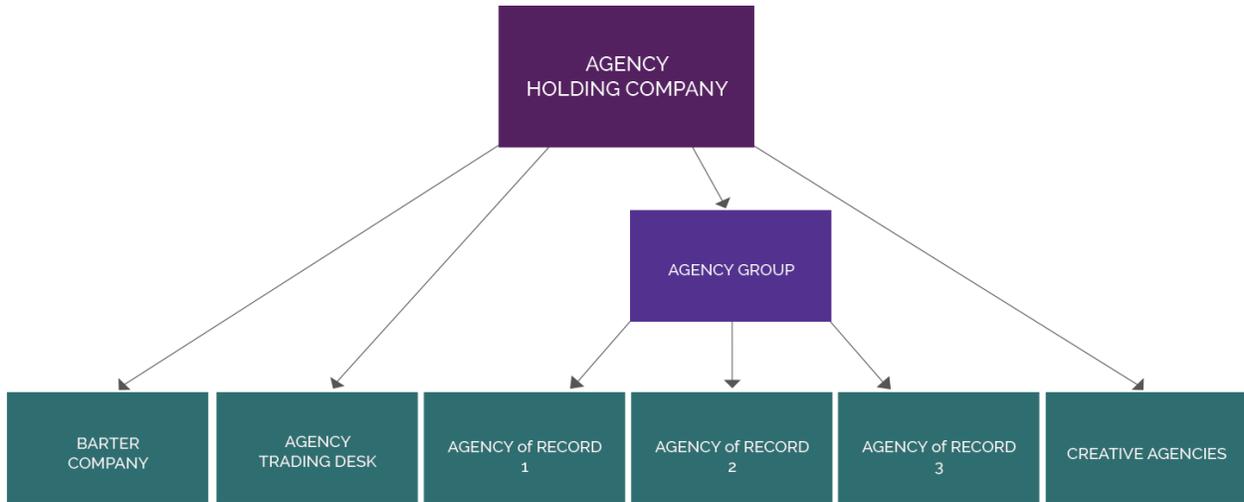
7. Glossary of Key Terms and Concepts

Ad Impression:	Any occasion when an ad, in any format or medium, is served to a consumer. In the context of online advertising, it means those occasions when an ad is served to a user's internet browser or mobile application. The number of impressions an ad achieves is a common performance metric.
Ad Tech:	This term is short for advertising technology, and refers to technologies that enable the automated buying and selling of advertisements. These include demand-side platforms ("DSP") and supply-side platforms ("SSP") as well as companies that provide technology or data services for the delivery and targeting of digital ads. These technology and data companies may purchase and resell media, acting functionally as media suppliers.
Advertiser:	Any organization that advertises its goods and services through paid, earned or owned media placements. With respect to the agencies, sometimes referred to as "client."
Agency Group:	A parent company of media agencies and other related entities that is itself owned by an Agency Holding Company.
Agency Holding Company:	A parent corporation that controls a network of companies, including advertising agencies, media agencies, barter, public affairs, data management, communications and/or other entities. In this report, this term is used to refer to the parent entity for one of the six largest global agency networks.
Agency of Record ("AOR"):	The media agency that contracts with an advertiser to purchase advertising space and time on its behalf.
Agency Trading Desk ("ATD"):	A trading entity used for buying and reselling online advertising space, controlled by an Agency Holding Company.
Agency Volume Bonus ("AVB"):	Another name for a rebate.
Barter Company:	A barter company trades in goods and/or services in addition to using a medium of exchange, such as cash. In the advertising context, barter companies trade media for goods, services, and cash.
Contingent Equity:	For purposes of this report, a stock option or warrant.
CPM:	The cost of placing an ad based on the price of 1,000 impressions, or "cost-per-thousand."
Creative Agency:	An agency employed by advertisers to plan, design, and execute their advertising content.
Demand-Side Platform ("DSP"):	A technology platform that enables advertisers and agencies to buy digital ads in an automated fashion.

Master Service Agreement (“MSA”):	For the purposes of this report, an MSA is a contract between an advertiser and agency in which both parties agree to terms that govern future transactions and/or agreements, including items such as media planning and buying, or agency compensation.
Media Agency:	An agency that (a) advises companies on how and where to advertise, (b) negotiates with various media suppliers to obtain time and space for advertisements, and (c) places and manages advertising schedules. ⁵³
Media Supplier:	An individual, enterprise or corporation that sells media inventory to media agencies or directly to advertisers.
Out-of-Home Advertising (“OOH”):	Advertising formats that reach consumers while they are outside their homes, such as billboards, bus wraps, subway posters, or airport dioramas.
Programmatic:	The automation of media-buying and media-selling processes and decisions, enhanced through data.
Rate Card:	A sheet of prices and descriptions for the various ad placement options available from a media supplier.
Rebate:	Any benefit that a media supplier provides to a media agency, or an entity within an Agency Holding Company, representing a portion of the amount that an agency, or an entity within an Agency Holding Company, spends on media purchases with that media supplier. Also known as an agency volume bonus (“AVB”).
Stock Warrants:	A security that entitles the holder to buy the underlying stock of the issuing company at a fixed price, called exercise price, until the expiration date. Warrants and options are similar in that the two contractual financial instruments allow the holder special rights to buy securities. Both are discretionary and have expiration dates.
Supply-Side Platform (“SSP”):	A technology platform designed to facilitate the management and monetization of online media inventory by media suppliers. SSPs offer ad impressions for sale to a range of ad exchanges and DSPs.

⁵³ In this report, unless otherwise stated, any reference to “agency” refers to a media agency.

Diagram J: Relationship of Key Agency Holding Company Entities⁵⁴



⁵⁴ Please note that this diagram is intended to capture the relationship between certain key Agency Holding Company entities cited in this report and is not intended as a comprehensive corporate structure of an Agency Holding Company.

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