

Marketplace leakage^{*}

Andrei Hagiu[†] and Julian Wright[‡]

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Abstract

A key issue for the design of online marketplaces is addressing leakage. Buyers may use the marketplace to discover a seller or to obtain certain conveniences, but the seller may then want to take transactions off the marketplace to avoid transaction fees. Assuming buyers are heterogenous in their switching cost or inconvenience cost of purchasing directly, we provide a model in which there is partial leakage in equilibrium. We use the model to analyze the tradeoffs associated with different strategies the marketplace can use to attenuate the effects of leakage: investing in transaction benefits, limiting communication, charging referral fees, using price-parity clauses, introducing seller competition on the marketplace and hiding sellers that try to induce too much leakage.

Keywords: platforms, disintermediation, showrooming, steering, two-sided markets.

1 Introduction

Leakage, the phenomenon of platform participants meeting via a platform but taking their transactions off the platform, is a common problem facing platforms (namely, marketplaces) that attempt to charge transaction fees.¹

Marketplaces use a variety of instruments and measures to combat this issue: investing in additional benefits of completing transactions on the marketplace (e.g. escrow, insurance, and payment facilities on Airbnb, Amazon, eBay, Preply), charging only for referrals and not transactions (e.g. Capterra, Thumbtack), obscuring some information about transaction parties in order to make it more difficult for them to find each other outside the marketplace before completing the transaction (e.g. Airbnb, AngelList, eBay, Preply, Upwork), penalizing

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[†]Boston University Questrom School of Business, E-mail: ahagiu@bu.edu

[‡]Department of Economics, National University of Singapore, Singapore, E-mail: jwright@nus.edu.sg

¹Leakage is also sometimes referred to as disintermediation or showrooming.

sellers who attempt to take buyers off the platform by demoting them in search results (e.g. Booking.com, Expedia, CoachUp), and imposing price parity clauses to prohibit sellers from attracting buyers with lower prices to their own websites (e.g. Booking.com and Expedia) or bans if providers are caught taking clients off the platform (Preply, Upwork).

In this paper we provide a simple model to study how a marketplace should optimally respond to a leakage problem. In our benchmark setting there is a single monopoly seller that wants to sell to buyers who have unit demand. The marketplace charges a transaction fee when buyers purchase from the seller on the marketplace. Buyers discover the seller (and its prices) on the marketplace, and face additional costs to complete the transaction directly, i.e. outside the marketplace. The buyers' reluctance to transact directly could reflect a disutility due to the marketplace's superior transaction infrastructure (e.g. payments, security, shipping logistics, etc.) or a cost of switching to purchase directly. The seller sets two prices: one for buyers who purchase from it via the marketplace and one for buyers who purchase directly. Reflecting the heterogeneity in buyers' reluctance to purchase directly, the greater the discount the seller offers for buyers to transact directly, the more such buyers it can attract directly and thereby avoid paying the marketplace's transaction fee.

In this setting, we show that the marketplace always sets a fee that induces some (but not complete) leakage to arise in equilibrium. The extent of leakage that arises in equilibrium depends on how much the seller is willing to lower its direct price below the one it offers on the marketplace—a higher marketplace fee leads the seller to offer a bigger discount for direct transactions. The marketplace takes this relationship into account in setting its profit maximizing fee. As the underlying leakage problem becomes less severe (i.e. buyers are more reluctant to switch to purchasing directly), the marketplace's fee increases (up to some maximum level) and it makes strictly more profit in equilibrium.

We then explore six different strategies the marketplace can use to avoid or limit leakage: (1) investing in transaction benefits, (2) limiting communication between buyers and sellers, (3) charging the seller for referrals instead of (or in addition to) for transactions, (4) using a price-parity clause to rule out leakage, (5) allowing a competing seller to also sell on the marketplace, and (6) allowing seller competition but also steering in favor of one or the other seller, depending on how much leakage each seller induces. For each of these strategies, we analyze the tradeoff that it creates for the marketplace, and we analyze how the tradeoff depends on buyers' switching costs (which capture the propensity for leakage) and other relevant parameters.

We obtain a number of new insights from analyzing the tradeoffs these strategies create for the marketplace. We show how a marketplace's investment incentives in transaction benefits depend on how easy (hard) leakage is. Indeed, we find a non-monotonic relationship, in

which the marketplace should invest more when leakage is either very easy or very hard. We show that limiting communication between buyers and sellers to reduce leakage creates a tradeoff by increasing buyer uncertainty about the suitability of sellers’ products. Taking this tradeoff into account, we show that the marketplace should ban communications when the propensity for leakage is high, and when the resulting loss of information for buyers is either sufficiently low or sufficiently high. Charging referral fees instead of transaction fees allows the marketplace to sidestep leakage, but at the cost of losing the ability to price discriminate based on (uncertain) buyer demand for the seller. However, we also show that leakage creates a complementarity between the two types of fees when the marketplace uses both: a higher referral fee raises the seller’s expected demand conditional on participating, which means the marketplace can also increase its transaction fee. Finally, we show that introducing seller price competition can actually worsen the leakage problem, because it induces involuntary leakage, but this result is reversed if the marketplace can steer buyers to the seller that induces less leakage.

2 Literature review

By now there is an extensive literature studying the implications of showrooming (consumers visiting an offline seller to search for the right product and then switching to buy the product online at a cheaper price) and webrooming (consumers doing their initial search online and then purchasing their chosen product offline). This literature has examined how competition between different combinations of online and/or offline sellers works when switching between competing sellers and/or channels is possible (Wu et al., 2004, Shin, 2007, Loginova, 2009, Balakrishnan et al., 2014, Jing, 2018, and Bar-Isaac and Shelegia, 2022). The key difference in our setting is that the underlying leakage problem arises from consumers choosing between buying from the same seller (or sellers) either on a marketplace or directly.

Our focus is also different in that we evaluate different strategies that the marketplace can use to address the “showrooming” problem. Related strategies have been looked at in other environments. An earlier economics literature explored restrictions (price floors and restricted territories) imposed by manufacturers in order to limit free riding across the retailers that sell their products, which in turn ensures each retailer retains an incentive to promote the manufacturer’s products (Telser 1960 and Mathewson and Winter 1984). Mehra et al. (2018) consider strategies (price matching and exclusive products) that offline stores use to counter traditional showrooming. Jing (2018) studies how the showrooming problem faced by an offline seller competing with an online seller is affected by the ability

of the offline seller to open its own online store. In our marketplace setting, the strategies considered and the incentives to choose them are very different, given the purpose is not to protect a seller from competition from other sellers, but rather to stop a seller from inducing its consumers to buy from it directly so as to avoid the marketplace’s transaction fees.

The setting in our paper is closest to Wang and Wright (2020) who look at a platform’s use of a price-parity clause that prevents third-party sellers from undercutting in their direct channel (or other cheaper channels) so as to eliminate showrooming. Theirs is a search framework with many sellers, and consumers search on the platform to discover their ideal match. In the absence of a price-parity clause, consumers are able to switch costlessly to buy directly from the seller of their choice, and taking this into account, the platform will always set a fee that prevents any leakage from happening in equilibrium. Our framework differs in that switching costs are heterogeneous, so switching does end up happening in equilibrium, even with a monopoly seller. Moreover, we look at the profitability of many different strategies a platform can use to address the leakage problem, including the price-parity clause they consider.

There is also an emerging empirical literature that studies marketplace leakage and the factors that give rise to it. Hunold et al. (2020) provide evidence of steering in response to leakage on hotel booking platforms — they show Booking and Expedia give less prominent placement to hotels that have lower prices on the hotel’s website or on a competing platform’s site. Gu and Zhu (2021) show that more online trust between consumers and third-party freelancers increases leakage on an online freelancer marketplace. For a similar type of online labor marketplace, Zhou et al. (2021) show higher customer-agent interaction frequency, higher transaction prices, service repetitiveness and proximal customers are some of the factors that also increase leakage.

Our paper fits within a broader literature that analyzes various non-price design choices faced by platforms. Broad frameworks for looking at these choices include Bhargava (2022), Choi and Jeon (2022), and Teh (2022). Some of the strategies we consider to address leakage such as limiting communication and steering buyers have been studied by others in different contexts. However, most papers on platform design do not consider the possibility of leakage as a factor explaining design choices. An exception is Peitz and Sobolev (2022) who study conditions under which a platform will make inflated recommendations to buyers on whether to purchase from a seller whose product the platform has superior information about. In an extension, they show how the possibility of leakage makes the platform more inclined to induce the inflated recommendations outcome.

Edelman and Hu (2017) contains a closely related informal discussion of various strategies to combat leakage (which they call “disintermediation”). At a high level, some of the

strategies we formally analyze do overlap with those discussed by Edelman and Hu. However, as emphasized in the introduction, our analysis tackles important tradeoffs which are not covered in their discussion, such as how a marketplace’s investment incentives in transaction benefits depend on how easy (hard) leakage is, the tradeoffs associated with limiting communication between buyers and sellers to reduce leakage, how referral fees and transactions fees can be complementary in a setting with leakage, and the desirability of adding a competing seller and steering buyers between sellers to reduce leakage.

3 Baseline model

We first lay out our model’s assumptions (Section 3.1) and then discuss these (Section 3.2).

3.1 Assumptions

There is a single platform (marketplace) M , a single seller S and measure one of buyers that each wish to purchase one unit of S ’s product. S ’s product is valued at v by all buyers and it incurs a marginal cost equal to c , where $v > c$. The buyers have an outside option valued at zero.

S can sell to buyers through two channels: via M , in which case it must pay M a fee per transaction f , or via its direct channel (with no transaction fee). S can set different prices across these two channels: p_m when selling via M and p_d in its direct channel. Facing these prices, buyers make their purchase and channel decisions.

Buyers have a preference for using M . They face no cost of going to M , and they face a disutility s of buying directly from S , which is drawn from a distribution G on the interval $[0, \bar{s}]$, with everywhere positive density on $(0, \bar{s})$. This bias in favor of M can be interpreted in two different ways. One is that buyers are uninformed about the existence of S , so they rely on M to discover S (and its prices in both channels), after which they face a cost s to switch and buy directly from it. The other is that they already know about S ’s existence, but they perceive a disutility s if they buy directly instead of through M . For instance, this could reflect that direct payments to S are less convenient or seem less secure, or logistics are inferior in the case of shipping a product directly rather than via M . Either interpretation of buyers is allowed in our baseline model, and indeed, there may be some buyers of each type.

These interpretations allow us to cover different types of applications. In case M is a marketplace and S is an individual (e.g. Airbnb, CoachUp, eBay, Etsy, Fiverr, OpenSea,

Preply, Rover, TaskRabbit, Upwork etc.), it is natural to think of all buyers discovering the seller via a marketplace. On the other hand, if M is a marketplace for brands that have their own websites (e.g. Amazon.com, Apple’s App Store, Booking.com, Tmall), some buyers may be aware that a seller they are interested in has its own website, but they might still feel that going through the marketplace is more convenient or more secure.

The timing is completely natural. There are three stages: (i) M sets its fee f ; (ii) observing the fee, S sets its price p_d , and if it decides to list on M , sets its price p_m as well; and (iii) buyers observe both prices² and decide whether to buy and which channel to use.

3.2 Discussion

Before proceeding, it is useful to briefly discuss our key assumptions. One might think a simple way to avoid leakage is to charge S a fixed fee for listing instead of a fee per transaction. However, in practice many marketplaces, such as those discussed above, derive most of their revenues from transaction fees charged to their sellers.³ There are several reasons for this. One is that sellers typically face budget constraints, so are unable to pay the marketplace upfront for the value they expect to get from all future transactions. Another is that in reality, there is considerable heterogeneity and uncertainty in the demand and/or revenue that sellers expect to obtain on the marketplace, which means a fixed fee that tries to fully extract a seller’s surplus may result in the seller not participating at all. In Online Appendix A, we show how our baseline model analysis and results extend to allow for a fixed access fee that extracts an exogenous fraction of S ’s surplus. In Section 5.3, we consider the possibility of fixed *referral* fees, which are different from fixed access fees in that they are paid per buyer brought to the seller. Finally, note that with unit demand and positive marginal costs, an ad-valorem (i.e. proportional) fee is equivalent to a per-unit transaction fee, something we prove for our baseline model in Online Appendix B. For this reason, we stick with a per-unit fee for expositional purposes.

Although we will analyze the case with competing sellers in Section 5.5, for most of our analysis we focus on the simpler case with a single seller. The way we interpret the single seller in our model is that M is actually a marketplace for many different independent sellers, and our analysis applies to each one of them. Alternatively, if different sellers are ex-ante

²This could be either because S communicates p_d to buyers who find it on M (which is in S ’s interest to do), or because each buyer who finds S can costlessly check the direct price p_d (the disutility s is only incurred if the buyer actually purchases in the direct channel).

³Some marketplaces do charge both fixed access fees and transaction fees (e.g. Apple for iOS developers and Amazon for its third-party sellers). However, the fixed fees are typically a very small part of total revenue and they mostly serve the purpose of screening sellers that would just waste the marketplace’s time, reflecting fixed costs to the marketplace of onboarding and handling these sellers. In other cases, there can be monthly access fees associated with software provided by the marketplace (e.g. Open Table).

identical other than the measure of buyers that are interested in each, our analysis would still apply even if M could only set a single fee across all the different sellers since each seller's and M 's profit would just scale with this measure, and the choice of M 's optimal fee would remain.

A final key assumption is that buyers are homogenous in their willingness-to-pay for S 's product. Allowing for heterogeneity in this willingness-to-pay would create downward sloping demand for S 's product, but would destroy the tractability of our framework because it would mean we have two dimensions of heterogeneity: willingness-to-pay for the product and willingness-to-pay across the two channels. S 's optimal prices no longer have closed-form solutions, which makes it hard to say much about M 's optimal fee or other strategies to avoid leakage.

4 Baseline analysis

Each buyer draws a switching cost (or disutility) s and purchases directly iff

$$v - p_d - s \geq \max \{v - p_m, 0\}.$$

The buyer compares the direct channel with the best alternative: buying on M if $p_m \leq v$, or the outside option, which gives utility of zero.

We can simplify the analysis by eliminating weakly dominated strategies to obtain the following preliminary result (proof is in the appendix).

Lemma 1. *M 's optimal fee and S 's optimal prices satisfy $0 < f \leq v - c$ and $p_d < p_m = v$.*

These properties are intuitive. M must choose a positive fee f , but low enough so that S can make non-negative profits selling through M . Meanwhile, S will set its price to extract the entire buyer surplus on M and will undercut in the direct channel, in order to attract buyers with the lowest switching costs and avoid paying M 's fee when selling to them.

Given Lemma 1, S 's pricing problem reduces to setting $p_d \leq v$ to maximize its profit

$$\pi = (p_d - c) G(v - p_d) + (v - c - f) (1 - G(v - p_d)). \quad (1)$$

Since S can attract all buyers to purchase directly by setting $p_d \leq v - \bar{s}$ (where \bar{s} is the upper bound of the support of $G(\cdot)$), then S will never want to price less than $v - \bar{s}$. Thus, S 's optimal p_d is such that $v - \bar{s} \leq p_d \leq v$.

Denote by $p_d(f)$ the unique solution in p_d to the first-order condition (FOC)

$$G(v - p_d) - g(v - p_d)(p_d - (v - f)) = 0,$$

so that

$$p_d(f) = v - f + \frac{G(v - p_d(f))}{g(v - p_d(f))}. \quad (2)$$

Provided G is well behaved⁴, so there is a unique solution to this FOC that characterizes the profit maximizing price, $p_d(f)$ is decreasing in f . The higher the transaction fee charged by M , the more aggressively S will price in the direct channel in order to induce leakage.

S 's profit maximizing price $p_d^*(f)$ is then given by

$$p_d^*(f) = \begin{cases} v - \bar{s} & \text{if } p_d(f) \leq v - \bar{s} \\ p_d(f) & \text{if } v - \bar{s} \leq p_d(f) \leq v \\ v & \text{if } p_d(f) \geq v \end{cases} .$$

The corresponding profit for M is

$$\Pi(f) = f(1 - G(v - p_d^*(f)))$$

so

$$\Pi^* = \max_{f \leq v - c} \{f(1 - G(v - p_d^*(f)))\}. \quad (3)$$

The expression of M 's profits reflects the leakage tradeoff. If $f = 0$, S will set $p_d = v$ since it has no reason to try to shift transactions to the direct channel. However, once $f > 0$, because there are some buyers with s arbitrarily close to 0, S will always want to lower p_d to induce some leakage. As M increases f further, it leads S to price more aggressively in the direct channel (i.e. lower p_d^*), which means more leakage and fewer transactions on M . This implies $\Pi^* < v - c$ since at $f = v - c$, some buyers will no longer purchase on M .

Initially, we are interested in the effect on the equilibrium fee, the direct price, leakage and M 's profit of changing the distribution of switching costs so that overall, buyers have higher switching costs. The immediate effect of higher switching costs is that the direct channel is relatively less appealing to buyers, which should increase M 's profits as fewer buyers switch (all other things equal). On the other hand, precisely because the direct channel is less appealing, S has to price more aggressively in the direct channel to attract buyers, which leads more buyers to switch. Finally, M can respond to leakage being less

⁴A sufficient condition is that g is continuous over its support, and is weakly decreasing in its argument, so that G/g is strictly decreasing in $p_d(f)$.

appealing by raising its fee, or it can respond to S pricing more aggressively in the direct channel by lowering its fee. Either way, M 's optimal adjustment of its fee can help mitigate the effect on leakage of a change in switching costs.

To obtain more specific results, we proceed by assuming G is the uniform distribution; i.e.

$$G(s) = \frac{s}{\mu},$$

for $s \in [0, \mu]$, where $\mu > 0$, with $G(s) = 0$ for $s < 0$ and $G(s) = 1$ for $s > \mu$. This ensures we can get closed form solutions.⁵ We are interested in how things change when switching costs increase. Switching costs can be interpreted as capturing the underlying propensity for leakage: higher switching costs correspond to a lower propensity for leakage (holding everything else constant). A change in switching costs could arise from an exogenous shock in preferences or technology, or it could be the result of strategic design decisions by M . We capture an increase in switching costs by increasing μ . If $\mu_2 > \mu_1 > 0$, then $G_2(s)$ stochastically dominates $G_1(s)$, so an increase in μ corresponds to an overall increase in switching costs in the sense of first-order stochastic dominance.⁶

Assuming $f \leq v - c$, we have

$$p_d(f) = v - \frac{f}{2}$$

and therefore S 's profit maximizing price $p_d^*(f)$ is given by

$$p_d^*(f) = \begin{cases} v - \mu & \text{if } f \geq 2\mu \\ v - \frac{f}{2} & \text{if } f \leq 2\mu \end{cases}. \quad (4)$$

The corresponding profit for M is

$$\Pi(f) = \begin{cases} 0 & \text{if } f \geq 2\mu \\ f \left(1 - \frac{f}{2\mu}\right) & \text{if } f \leq 2\mu \end{cases}. \quad (5)$$

Recalling that M will always set $f \leq v - c$, and relegating the details to the appendix, we obtain the following proposition.

Proposition 1. *Suppose $G(s) = \frac{s}{\mu}$ and $\bar{s} = \mu$. There is always positive but partial leakage equal to $\frac{1}{\mu}(v - p_d^*(\mu))$, where the equilibrium transaction fee, direct price and marketplace*

⁵We can still get closed form solutions provided G is a power function. In Online Appendix C we repeat the analysis of the model in this section with $G(s) = \frac{1}{\mu}s^\alpha$ for $s \in [0, \mu^{\frac{1}{\alpha}}]$ and show we get the same qualitative results. We stick to the simpler linear function for exposition purposes.

⁶Formally, G_2 first-order stochastically dominates G_1 if $G_2(s) \leq G_1(s)$ for all s , with strict inequality over an interval with positive measure.

profit are as follows:

$$\begin{aligned}
f^*(\mu) &= \min\{\mu, v - c\} \\
p_d^*(\mu) &= v - \min\left\{\frac{\mu}{2}, \frac{v - c}{2}\right\} \\
\Pi^*(\mu) &= \begin{cases} \frac{\mu}{2} & \text{if } \mu \leq v - c \\ (v - c)\left(1 - \frac{v - c}{2\mu}\right) & \text{if } \mu \geq v - c \end{cases} .
\end{aligned} \tag{6}$$

In response to an increase in switching costs (an increase in μ), the marketplace's fee weakly increases, the seller's direct price weakly decreases, the extent of leakage weakly decreases, and the marketplace's profit increases.

Given there are some buyers with arbitrarily small switching costs, any positive fee will lead to some leakage. However, it never makes sense for M to set a fee that leads all buyers to switch to purchase directly. At such a high fee, it will get no demand. This is why there is always positive but partial leakage in equilibrium.

Proposition 1 says that M 's fee increases and it does better when switching costs of buying directly increase (in the first-order stochastic sense), while S 's direct price and leakage decrease as a result. To unpack the effects of an increase in switching costs, consider what happens as μ increases starting from a low level (i.e. where switching costs are relatively low). First note that in the range of fees at which M still has some demand (i.e. $f < 2\mu$), (4) implies that S 's direct price only changes in response to a change in M 's fee and does not depend on μ directly. If fewer buyers purchase directly as a result of higher switching costs, M will want to increase its fee. S will respond by decreasing its direct price to induce more buyers to switch in order to avoid M 's higher fee. This decrease in S 's direct price mitigates the initial decrease in leakage, and indeed turns out to leave the net amount of leakage unchanged. But with a higher fee, M is strictly better off.

As switching costs μ continue to increase above $\mu = v - c$, M 's fee is pushed to the maximum level $v - c$ beyond which S would drop out. At this point, further increases in switching costs will not lead to any further increase in M 's fee, and so S no longer decreases its direct price. With S 's direct price held constant, we are only left with the immediate effect of higher switching costs, which is to decrease leakage and increase M 's profit.

5 Strategies to mitigate leakage

In this section we explore six alternative strategies that can help mitigate leakage: (1) investing in transaction benefits, (2) limiting communication, (3) charging the seller for

referrals rather than for transactions, (4) using a price-parity clauses to rule out leakage, (5) adding a rival seller onto the marketplace; and (6) in the case there is an alternative seller that the marketplace can show, hiding the seller if it tries to induce too much leakage. In each case, we explain the tradeoffs that arise from using the alternative strategy, modifying the baseline model as necessary to capture the relevant tradeoff. And we explore how the tradeoffs change as we increase switching costs.

5.1 Investing in transaction benefits

A direct way the marketplace could try to reduce or even eliminate leakage is by offering buyers some benefits from completing transactions on the marketplace. This means that buyers and sellers have an incentive to use the marketplace even for repeat interactions. For example, StyleSeat, a marketplace that helps consumers discover and book appointments with beauty salons and stylists has added the ability to pay through the platform, schedule bookings 24/7, receive personalized reminders, handle last minute cancellations, manage receipts and records of past transactions, and handle no-shows and rebookings.

We model this by assuming that M must invest $K(b)$ to provide buyers with a benefit b from completing their transaction on M , where $K(b)$ is an increasing and convex function of b (one could conduct an equivalent analysis if the benefit was relevant to S , or to both buyers and S ⁷). The baseline model is otherwise unchanged. Our goal in this section is to study how M 's optimal level of investment in transaction benefits and the resulting amount of leakage depend on the magnitude of switching costs.

Suppose M has chosen b and consider the resulting game. A buyer with switching cost s purchases directly iff

$$v - p_d - s \geq \max \{v + b - p_m, 0\}.$$

Following the same logic as in the baseline, M always sets $f \leq v + b - c$ and S sets $p_m = v + b$ and $p_d \leq v$. Thus, the decision S now faces is to set $p_d \leq v$ to maximize its profit

$$\pi = (p_d - c) G(v - p_d) + (v + b - c - f) (1 - G(v - p_d)).$$

S 's profit-maximizing price $p_d^*(f)$ is given by

$$p_d^*(f) = \begin{cases} v - \bar{s} & \text{if } p_d(f) \leq v - \bar{s} \\ p_d(f) & \text{if } v - \bar{s} \leq p_d(f) \leq v \\ v & \text{if } p_d(f) \geq v \end{cases},$$

⁷It also does not matter whether M invests in b before or after (or at the same time) it sets its fee f , provided it is chosen before S sets its prices.

where

$$p_d(f) = v + b - f + \frac{G(v - p_d(f))}{g(v - p_d(f))}.$$

Provided G continues to be well behaved (as in the baseline), so there is a unique solution to this FOC that characterizes the profit maximizing price, $p_d(f)$ is decreasing in f and increasing in b .

A key difference relative to the baseline is that S no longer has an incentive to induce leakage (i.e. set $p_d^*(f) < v$) as soon as $f > 0$. Rather, it only has an incentive to induce leakage when $f > b$. This is because, as long as $f \leq b$, the seller S 's margin on M (equal to $v + b - c - f$) is higher than the maximum margin it can obtain in its direct channel ($v - c$). Taking this into account, M will always set $f \geq b$. Provided M has chosen $b > 0$, it has the option to set $f = b$ and obtain a profit of $b - K(b)$ given there is no leakage. Alternatively, it can set a higher fee ($f > b$) and face some leakage.

Stepping back to the first-stage problem that also involves setting b , the corresponding profit for M is

$$\Pi^* = \max_{\substack{b \geq 0 \\ b \leq f \leq v - c + b}} \{f(1 - G(v - p_d^*(f))) - K(b)\}.$$

To obtain closed form solutions with full characterization of the optimum, we adopt the same uniform distribution as in the baseline model and assume K is quadratic. Relegating the calculations to the appendix, we obtain the following proposition.

Proposition 2. *Suppose $G(s) = \frac{s}{\mu}$ and $\bar{s} = \mu$, and $K(b) = \frac{k}{2}b^2$, with $k > 0$. Then the marketplace's optimal choice of transaction benefits is*

$$b^* = \begin{cases} \frac{1}{k} & \text{if } \mu \leq \frac{1}{2k} \\ \frac{1}{2k - \frac{1}{2\mu}} & \text{if } \frac{1}{2k} \leq \mu \leq \bar{\mu} \\ \frac{1}{k} - \frac{v-c}{2k\mu} & \text{if } \mu \geq \bar{\mu} \end{cases},$$

where

$$\bar{\mu} = \frac{v-c}{2} + \frac{1}{4k} + \sqrt{\left(\frac{v-c}{2}\right)^2 + \frac{1}{16k^2}}.$$

The marketplace's optimal level of investment in transaction benefits b^ is decreasing in the investment cost k , and initially constant in switching costs μ , then decreasing in μ for $\mu \in [\frac{1}{2k}, \bar{\mu}]$, and finally increasing in μ for $\mu \geq \bar{\mu}$. Meanwhile, the equilibrium amount of leakage is initially constant at zero, then increasing in μ for $\mu \in [\frac{1}{2k}, \bar{\mu}]$, and finally decreasing in μ for $\mu \geq \bar{\mu}$.*

The result in Proposition 2 that M 's investment in transaction benefits b^* is everywhere

decreasing in k is not at all surprising. Higher costs of investment naturally lead to less investment in transaction benefits.

More interesting and unexpected is the comparative static of b^* in μ . Proposition 2 shows b^* attains its minimum when M faces moderate switching costs ($\mu = \bar{\mu}$), and the highest level occurs at extreme levels of switching costs, i.e. $\mu \rightarrow 0$ and $\mu \rightarrow \infty$ (note indeed b^* tends to $\frac{1}{k}$ again as $\mu \rightarrow \infty$).

To explain this result, it is useful to trace through what happens as switching costs (measured by μ) increase. When they are sufficiently low, the competitive pressure of the direct channel is highest, so the most effective way for M to generate revenue is to set $f = b$, so S does not want to induce any leakage. With all buyers purchasing on M , it extracts the full marginal value of its investment in b , thereby setting b to maximize $b - K(b)$, and setting $b^* = \frac{1}{k}$. As μ increases from this low base (i.e. $\mu > \frac{1}{2k}$), value extraction becomes more attractive than avoiding leakage, and it becomes optimal for M to set $f > b$. This results in increasing leakage. With fewer buyers purchasing on M , the marketplace no longer extracts the full marginal value of an investment in b , so b^* decreases. In this intermediate range of switching costs, the equilibrium level of leakage is increasing in μ , reflecting higher fees and a lower level of investment in transaction benefits. Profits are still increasing in μ , but the higher switching costs allow the marketplace to no longer work as hard in terms of providing transaction benefits. Past a certain point however (i.e. for $\mu > \bar{\mu}$), the switching costs are high enough that the equilibrium amount of leakage starts to decrease as switching costs increase. This is the point where M sets its fee to extract the entire margin from S for transactions conducted on M (i.e. $f^* = v + b^* - c$). Since the fee cannot increase any further, any increase in switching costs from here onwards results in more buyers choosing to purchase via M instead of via the direct channel. This means M extracts a higher share of the total value created by transaction benefits, and so its investment incentive (its choice of b^*) is now increasing.

As is clear from our explanation above, the non-monotonic relationship between switching costs and both the marketplace's investment in transaction benefits and the resulting amount of leakage generalizes beyond the specific functional forms we have used (namely, a linear distribution function for switching costs). When switching costs are very low, the threat of leakage is highest, so the marketplace needs to invest a lot in transaction benefits to combat it. At intermediate levels of switching costs, M can slack off in terms of investing in transaction benefits and rely instead on higher switching costs to extract more from S (more than the value of its transaction benefits in fact). This means M 's incentives to invest in transaction benefits are diminished in this region. Once switching costs become very high, the threat of leakage is no longer constraining M 's fees, so the marketplace can afford to

extract the entire margin from the seller. This makes it more profitable for M to invest in something that can increase the margin it can extract from each customer, i.e. transaction benefits.

5.2 Limiting communication

In an effort to prevent leakage, marketplaces can make communication between buyers and sellers more difficult. This can involve hiding the identity of the parties and banning or restricting communications between them until after they have already committed to transact, thereby making it difficult for them to deal directly. Often, communications can only be done via the marketplace itself, and the marketplace blocks sharing of identifying information.

While these types of restrictions help reduce leakage, they also have a downside. Limiting communication on the marketplace can make it more difficult for buyers to ascertain the quality or suitability of the seller’s product. In other words, buyers are left with more uncertainty about the value of the seller’s product. For instance, AngelList and its syndicate leads connect investors with startup founders who are seeking to raise capital. Most syndicate leads on AngelList have very strict policies prohibiting investors to directly contact founders (e.g. via email). This makes it hard for investors to ask founders questions and to thoroughly evaluate their competence and the prospects of their startups.

In this section we capture the tradeoff associated with placing limits on communication in a simple way. Obviously, the strategy of limiting communication is only relevant to the extent buyers rely on M to discover S . To keep things as simple as possible, we will stick to that interpretation. We assume that a priori buyers have a probability $0 < q < 1$ of actually valuing S ’s product at v and probability $1 - q$ of valuing the product at zero. This covers the case all buyers have the same draw (v or zero), as well as the case each buyer draws their valuation independently with the same probability q . We treat q as a fixed parameter known to all parties.

If buyers are allowed to freely communicate with S , they can find out with certainty whether they value S ’s product or not, as well as its price in the direct market, just as in the baseline model. Alternatively, M has the option to ban communication between the buyer and S (e.g. by hiding the seller’s identity, requiring that all communication is intermediated and vetted by the marketplace, etc.). We assume that this effectively prevents buyers from being able to switch and buy from S directly. However, it also lowers the probability that any given buyer will find out their true valuation for S ’s product from one to $\eta \leq 1$.⁸ This

⁸The idea that limiting the exchange of information reduces transaction value on a platform is also present in Piolatto and Schuett (2022). However, Piolatto and Schuett do not consider the platform’s choice of how

means that with probability $1 - \eta$, a given buyer will never be sure whether their value for S 's product is v or zero, so they must make their purchase decision based on the expected value qv . Thus, our modelling approach treats limiting communication as a discrete decision (ban communication or not), whereas the impact on learning the valuation of the product is continuous. When $\eta = 1$, there is no information loss from banning communication, so M will always want to do so, as we will see. When $\eta = 0$, there is complete information loss, so all buyers make their purchase decisions based on expected value qv . The lower η , the higher the information loss.

If M does not ban communication, then things are straightforward. M 's and S 's pricing behaviors are the same as in the baseline, except all payoffs must be multiplied by q . Thus, M 's expected profit is $q\Pi^*$, where Π^* is given by (3).

Suppose now M bans communication. Assuming S lists on M , leakage is impossible so S 's only relevant price is the on-platform price p_m . It has two pricing options. The first one is to set $p_m = v$ and only sell to the fraction ηq of buyers who learn that their valuation of its product is v . Its resulting profit is $\eta q(v - c - f)$. The second option for S is to set the lower price $p_m = qv$, so that it also sells to the $1 - \eta$ buyers who never learn their true valuation for its product. Its resulting profit in this case is $(1 - \eta + \eta q)(qv - c - f)$. Thus, S prefers the first (high-price) option if and only if

$$f > \frac{(1 - (2 - q)\eta)qv}{1 - \eta} - c.$$

Otherwise, S chooses the second (low-price) option.

In turn, this implies that there are two possible optimal options for M when choosing f :

1. Set $f = v - c$, which induces S to choose the high-price option, resulting in M making a profit of $\Pi_H(\eta) = \eta q(v - c)$.
2. Set $f = \frac{(1 - (2 - q)\eta)qv}{1 - \eta} - c$, which induces S to choose the low-price option, resulting in M making a profit of $\Pi_L(\eta) = (1 - \eta + \eta q) \left(\frac{(1 - (2 - q)\eta)qv}{1 - \eta} - c \right)$.

Thus, M 's profit after banning communication is $\max\{\Pi_H(\eta), \Pi_L(\eta)\}$, which needs to be compared to the profit $q\Pi^*$ without any limits on communication. Relegating the rest of the analysis to the appendix, we obtain the following proposition.

Proposition 3. *The marketplace prefers to ban communication for all $\eta > \frac{\Pi^*}{v - c}$. If $q > \frac{c}{v - \Pi^*}$, then the marketplace also prefers to ban communication when $\eta < \eta_L$, where $\eta_L > 0$ is uniquely defined by $\Pi_L(\eta_L) = q\Pi^*$. If q is close enough to one, the marketplace always*

much information exchange to allow.

prefers to ban communication. Finally, if $G(s) = \frac{s}{\mu}$ and $\bar{s} = \mu$, then the marketplace will prefer to ban (allow) communication when μ is sufficiently close to zero (sufficiently large).

Recall $0 < \Pi^* < v - c$, so the first result in the proposition means there is always some cutoff between 0 and 1 such that for all higher η , the marketplace prefers to ban communication. This reflects that when η is close enough to one, the information loss from banning communication is small, while retaining the upside of eliminating leakage. Surprisingly, provided q is not too small (i.e. provided $q > \frac{c}{v - \Pi^*}$), then M also prefers to ban communication for η sufficiently close to zero.

To explain these properties, it is useful to note that $\Pi_H(\eta)$ is increasing in η , whereas $\Pi_L(\eta)$ is decreasing in η (whenever $\Pi_L(\eta) > 0$). To understand the difference, recall that option 1 involves only selling to buyers who learn that they value S 's product at v . When η is higher, the number of such buyers is larger (i.e. there is less information loss due to the communication ban), so M 's profit is also higher under the communication ban. Option 2 involves setting a lower fee such that S also sells to buyers who learn nothing. In this case, buyer demand is decreasing in η : fewer informed buyers means more buyers are willing to buy at $p_m = qv$, which makes this option more profitable for M , especially if q is high. Furthermore, the maximum fee f that M can charge under this option is higher when there are fewer informed buyers since S prefers option 2 when η is low and q is high. Both of these effects mean that, provided q is not too small and η is close enough to zero, M will also want to ban communication. Indeed, if q is high enough, then this means M will prefer to ban communication for the full range of η .

So essentially M has two choices when it chooses to ban communication. The first choice is to set f high enough so that S sets a high price at which only buyers who are informed and get the high draw end up buying. In this case, more information (i.e. higher η) is better for M because it increases demand—more buyers are informed. The second choice is to set f low enough so that S sets a low price at which buyers who are not informed and buyers who are informed and get the high draw end up buying. In this case, more information is worse for M because it reduces demand (higher η means fewer people are uninformed). Of course, M chooses the better of these two strategies, which is determined endogenously by η and q , but the point remains that either one can be optimal and the effect of information is different depending on which of the two strategies is optimal. If it is the first one, then banning communication is optimal for high enough η ; if it is the second one, banning communication is optimal for low enough η .

To further understand the logic of the second case, it is useful to note that when the information loss is already quite high (low η) such that M wants to induce S to price low

(at qv), the buyers who are informed and draw the high type are left with rent $(1 - q)v$, and there are ηq such buyers. In this case, further decreasing η decreases the total rent left to buyers, which helps S , and in turn M (given it can extract the rent via its fee).

5.3 Referral fees

Another way for a marketplace to fight leakage is to prevent the problem from arising in the first place: rather than charging the seller a transaction fee, it can charge the seller for referring buyers to it, i.e. informing them of its existence. For example, Thumbtack, a leading marketplace for home services, has adopted this approach: it charges service providers for new leads, without any transaction fees whatsoever.

To keep things as simple as possible, we focus on the interpretation of our model in which all buyers need to visit M to discover S , but then some switch to buy directly. In this scenario, M can sidestep the leakage issue by charging S only for referring buyers to it, and not based on whether or not the buyer completes the transaction on M .⁹ By just charging for each buyer that comes via M (regardless of whether they end up buying on M or directly), M eliminates S 's incentive to induce buyers to switch to purchase directly. This is because now S has the same marginal cost (c) regardless of whether it serves a buyer through M or directly. It is then easy to see that S will set $p_d = p_m = v$ and make $v - c - r$ for each buyer referred by M , where r is the referral fee. Indeed, referred buyers purchase on M since they have no reason to incur s given the prices are identical. The alternative for S is not to sign with M and get nothing, given that all buyers rely on M to discover S . This implies M can charge $r = v - c$, so S is just willing to accept referrals from M , and M obtains a profit of $v - c$. This is strictly higher than M 's profit in (3) with a transaction fee, which as noted there, is strictly less than $v - c$. Thus, in this simple framework, M always prefers to use a referral fee over a transaction fee.

Given this, one may wonder why we don't observe a majority of marketplaces that face leakage use referral fees instead of transaction fees. A key reason is that referral fees are quite risky from the point of view of sellers: they do not a priori know for sure they will get anything from the referral. The buyer may be a genuine buyer or one that turns out not to be interested. As a result, the referral fee must be lowered to compensate sellers for this risk. More generally, a referral fee (or any kind of fixed fee) eliminates the marketplace's ability to price discriminate across buyers that differ in the size, value or number of their transactions. This is why a fee charged at the transaction level may work better than a fee that is a fixed amount per buyer. To show this formally, we introduce uncertain buyer demand and show

⁹This type of referral fees has also been studied by Condorelli et al. (2018), who look at whether an intermediary should charge for referrals rather than buying and reselling.

that it generates a realistic tradeoff for M between using referral fees and using transaction fees.

We model uncertain buyer demand by assuming M does not know ex-ante (when it sets its fee) the demand facing S . Specifically, we assume all buyers have the same probability q of actually valuing the product at v and therefore conducting a transaction, and probability $1 - q$ of valuing the product at zero, but M does not know q . Once again, this is compatible with two interpretations: all buyers have the same draw (v or zero) or each buyer draws their valuation (v or zero) independently, with the same probability q .¹⁰ When M sets its fee, it only knows the prior distribution of q . For simplicity, we describe this by a continuous distribution function H on the interval $[\underline{q}, \bar{q}]$, where $0 \leq \underline{q} < \bar{q}$ and \bar{q} is not necessarily finite. This distribution H is assumed to be independent of the distribution G . Other than the introduction of random q , everything else is assumed to be the same as before.

Consider first the case M charges a transaction fee f , as in the baseline. The timing is now as follows:

1. M sets its transaction fee f
2. The value of q is drawn and, having observed it, S decides whether to accept the contract or not
3. S sets its prices (both direct and, if it accepts the contract, on M)
4. Buyers visit M and are informed of S if it is listed on M . Buyers then realize the value of the product, before deciding whether to purchase, and if so, in which channel. S pays f to M for each transaction on M .

The choices of M 's optimal fee f and S 's optimal prices p_m and p_d are identical to before because all payoffs are multiplied by q , but q does not affect the choices between different options, including whether S should accept the contract. This is because in case a buyer values the product at zero, which happens randomly, such a buyer is irrelevant to S 's and M 's decisions and profit. Thus, M 's corresponding expected profit in this setting is just $\Pi^* \int_{\underline{q}}^{\bar{q}} q dH(q)$, where Π^* is the profit from the baseline model with no uncertainty given by (3).

Now consider the case where M instead charges S a referral fee for each referred buyer. The timing is as follows:

¹⁰If there was uncertainty over the number of buyers, then this would create a tradeoff between transaction fees and fixed fees. However, to generate a tradeoff between transaction fees and referral fees we need uncertainty over the number of transactions per buyer.

1. M sets its referral fee r
2. The value of q is drawn and, having observed it, S decides whether to accept the contract or not
3. S sets its prices (both direct and, if it accepts the contract, on M)
4. Buyers visit M and are informed of S if it is listed on M . S pays r to M for each such buyer referred. Buyers then realize the value of the product, before deciding whether to purchase, and if so, in which channel.

When M charges a referral fee, buyers can still decide whether to complete the transaction on M or buy directly. The key difference in this case is that, even if a buyer decides to purchase directly, S still has to pay for the referral of that buyer (since the buyer needed M to discover S).¹¹ Since there is no transaction fee, S has no incentive to lower its price in its direct channel, so all buyers will just purchase via M since they have no reason to incur the cost s to switch and buy directly.

If M knew the probability q that each buyer is actually interested in S 's product, it would optimally charge a referral fee $r = (v - c)q$ and extract all the expected surplus. But since M does not observe q , it has to take into account that a higher referral fee makes it less likely that S (which knows the value of q) will accept the offer. Specifically, S accepts the offer if and only if $(v - c)q \geq r$. If instead $(v - c)q < r$, then S rejects the offer and M makes no profit. Thus, M 's expected profit is $\max_r \{r (1 - H(\frac{r}{v-c}))\}$, or, defining $y = \frac{r}{v-c}$, the profit can equivalently be written as $(v - c) \max_y \{y (1 - H(y))\}$.

Comparing expected profits under the two types of fees, M 's profit is higher with a transaction fee if and only if

$$\Pi^* \int_{\underline{q}}^{\bar{q}} q dH(q) > (v - c) \max_y \{y (1 - H(y))\}. \quad (7)$$

From (3), we know that $\Pi^* < v - c$, as noted above. On the other hand, we also know that $\int_{\underline{q}}^{\bar{q}} q dH(q) > \max_y \{y (1 - H(y))\}$.¹²

Equation (7) captures the fundamental tradeoff a marketplace faces when choosing between referral fees and transaction fees. Referral fees sidestep the leakage problem, thereby allowing M to extract more surplus from buyers who are in fact interested in S 's product

¹¹In practice, this can take the form of a per-click referral fee, i.e. a fee that the seller pays for every buyer that clicks on the seller's profile on the marketplace or on the link to the seller's direct website.

¹²To see this, note if we define $q^* = \arg \max_q \{q (1 - H(q))\}$, then $\int_{\underline{q}}^{\bar{q}} q dH(q) - q^* (1 - H(q^*)) = \int_{\underline{q}}^{q^*} q dH(q) + \int_{q^*}^{\bar{q}} (q - q^*) dH(q) > 0$.

($v - c$ rather than Π^*). On the other hand, transaction fees allow M to extract more surplus when there is a lot of uncertainty around buyer demand (holding $\int_{\underline{q}}^{\bar{q}} q dH(q) = E[q]$ constant, $y(1 - H(y))$ is lower when H is more dispersed around $E[q]$) because they align the revenue extracted with buyer demand. Thus, if the leakage problem—measured by the magnitude of switching costs—is sufficiently severe (so Π^* is very low compared to $v - c$), then using referral fees is optimal. If there is too much uncertainty about buyer demand (so $\max_y \{y(1 - H(y))\}$ is very low compared to $\int_{\underline{q}}^{\bar{q}} q dH(q)$), then using transaction fees (and incurring some leakage) is optimal. In Online Appendix D.1, we make this intuition more precise by adopting specific functional forms for the distributions $G(\cdot)$ and $H(\cdot)$ and stating the tradeoff above as a formal proposition.

One could also use the same logic to show a very similar tradeoff between transaction fees and fixed access fees (instead of fixed referral fees). In that case, we would introduce uncertainty about the total number of buyers a seller would have access to through the marketplace instead of, or in addition to, the uncertainty about the demand of each individual buyer. However, using fixed access fees is less attractive than referral fees since it gives up even more ability to price discriminate (based on the total number of buyers a seller attracts via the marketplace). Thus, exclusively relying on fixed access fees should only be considered when it is not possible to charge the seller for each time a buyer is referred to the seller.

We now briefly discuss what happens when M can charge both a referral fee r and a transaction fee f . We can use the logic in the baseline model to conclude $0 < f \leq v - c$ and $p_d < p_m = v$. And S 's profit is

$$\max_{p_d \leq v} \{q((p_d - c)G(v - p_d) + (v - c - f)(1 - G(v - p_d))) - r\}.$$

Thus, S sets $p_d^*(f)$ as in the baseline model and participates on M iff

$$q\pi(f) - r \geq 0,$$

where

$$\pi(f) \equiv (p_d^*(f) - c)G(v - p_d^*(f)) + (v - c - f)(1 - G(v - p_d^*(f))).$$

M 's profit as a function of the referral fee r and the transaction fee f is then

$$\Pi(r, f) = \int_{q \geq \frac{r}{\pi(f)}} (r + qf(1 - G(v - p_d^*(f)))) dH(q).$$

It is easily seen that if $r = 0$, then

$$\Pi(0, f) = \Pi(f) \int_{\underline{q}}^{\bar{q}} q dH(q),$$

where $\Pi(f)$ is the same as in the baseline model. Thus, in this case, the optimal f is the same as in the baseline model.

And if $f = 0$, then the seller sets $p_d = v$, so

$$\Pi(r, 0) = r \left(1 - H \left(\frac{r}{v - c} \right) \right),$$

which is of course identical to the case in which only referral fees are used, analyzed above.

Denote $x = \frac{r}{\pi(f)}$, which can be interpreted as the fraction of S 's profit extracted by M via the referral fee. Then we can rewrite M 's profit as

$$\Pi(x, f) = \int_{q \geq x} (x\pi(f) + qf(1 - G(v - p_d^*(f)))) dH(q).$$

Thus, for every draw of q such that S participates, M extracts $x\pi(f)$ via the referral fee and $qf(1 - G(v - p_d^*(f)))$ via the transaction fee.

The expression above reveals that the referral fee now plays a dual role. First, it provides a way to obtain revenue while avoiding leakage. For a given q such that $q \geq x$, it is easily verified that x and f are substitutes in maximizing $x\pi(f) + qf(1 - G(v - p_d^*(f)))$, i.e. when x increases, the transaction fee f that maximizes $x\pi(f) + qf(1 - G(v - p_d^*(f)))$ decreases (this is because $\pi(f)$ is decreasing in f). This is what one would expect based on the above analysis of the tradeoff between pure referral fees and pure transaction fees. However, the referral fee now also has a second effect: it acts as a screening device for S 's participation. Increasing the fraction of S 's profits extracted via the referral fee (i.e. increasing x) results in S participating less often, but it also results in it having a higher average probability of buyers liking its product when it does participate (i.e. $E[q|q \geq x]$ is higher), which means the optimal f can increase in response to an increase in r .

These observations help explain why M may find it optimal to use both referral and transaction fees. In Online Appendix D.2 we provide an example to illustrate this, in which $G(s) = \frac{s}{\mu}$ over $[0, \mu]$ and q can only take two values: $q_0 - \sigma$ with probability $\frac{1}{2}$ and $q_0 + \sigma$ with probability $\frac{1}{2}$. We find that the optimal transaction and referral fees are both positive and non-monotonic in the standard deviation σ of q . The reason is that when the standard deviation is not too high, M prices such that S always participates and in this case it is natural that more uncertainty over buyer demand leads M to lower the referral fee and

increase the transaction fee. However, once the standard deviation becomes too high, M finds it profitable to price such that S only participates when buyer demand is high ($q = q_0 + \sigma$), so now there is no longer any need to charge any transaction fee— M can extract the full surplus of S when buyer demand is high via a referral fee.

5.4 Price-parity clauses

Suppose the marketplace can require that the participating seller must set its direct price no lower than its price on the marketplace. If the seller sets a lower direct price, the marketplace commits to delist the seller. This type of clause in a contract is known as a price-parity clause (PPC). While this is not in the marketplace’s interest ex-post in case the seller does undercut given that it would deprive the marketplace of all revenue, being able to commit to such a clause can make the marketplace better off ex-ante if it stops the seller from undercutting in the first place. Such PPCs have been used by hotel booking platforms, price comparison platforms, as well as Amazon.

How a PPC works depends on whether buyers depend on M to discover S . If they do, then with this restriction in place, S will always be willing to stay on M provided $f \leq v - c$, since it cannot get any profit if it delists. As a result, S sets $p_d = p_m = v$ and M sets $f = v - c$, so M extracts the maximum profit $\Pi = v - c$, which is always strictly more than what it would get without a PPC. Thus, M will always impose a PPC, which results in higher direct prices for buyers.

Things are less obvious when buyers don’t depend on M to discover S since then S has the option of rejecting M ’s offer and still making positive profit by just selling directly. Still, without any uncertainty, a PPC is still always better for M (we show this in the appendix). Indeed, the PPC ensures that M ’s fee does not lead to any distortion (via leakage), so the transaction fee acts like a fixed fee. Given S does not want to induce leakage, it sets both its prices at v , and M ’s fee is just pinned down by making S indifferent between listing on M and not listing. This means M can extract the maximal possible surplus subject to S being willing to participate—there is no downside to imposing a PPC.

To see how a tradeoff from imposing a PPC can arise, we introduce asymmetric information about the nature of switching cost between the marketplace and the seller. The simplest way to do so is by assuming that with probability q buyer switching costs are distributed according to $G(\cdot)$ (the baseline state), and with probability $1 - q$ switching costs are infinite for all buyers, so none would ever switch (the no-switching state). M does not know which of the two states of the world prevails when it sets its fee (and potentially a PPC), but S does when it considers whether or not to accept M ’s offer.

Suppose M imposes a PPC. If S lists, it must set $p_d = p_m = v$ to comply with the PPC and it obtains $v - c - f$. If S delists, it obtains its normal payoffs $\max_{c \leq p_d \leq v} \{(p_d - c) G(v - p_d)\}$ in the baseline state (probability q) and zero in the no-switching state (probability $1 - q$). Thus, M has two choices when setting its transaction fee:

- set $f = v - c$, so S only accepts the offer in the no-switching state, resulting in profits for M of $(1 - q)(v - c)$.
- set $f = v - c - \max_{c \leq p_d \leq v} \{(p_d - c) G(v - p_d)\}$, so S always accepts the offer, resulting in profits for M of $v - c - \max_{c \leq p_d \leq v} \{(p_d - c) G(v - p_d)\}$.

Consequently, M 's overall profits under the PPC are

$$\Pi_{PPC}^* = \max \left\{ v - c - \max_{c \leq p_d \leq v} \{(p_d - c) G(v - p_d)\}, (1 - q)(v - c) \right\}.$$

If M does not impose the PPC, then S always accepts the contract and M 's profits are

$$\begin{aligned} \Pi^* &= \max_{f \leq v - c} \{f (q(1 - G(v - p_d^*(f))) + (1 - q))\} \\ &= \max_{f \leq v - c} \{f (1 - qG(v - p_d^*(f)))\}. \end{aligned}$$

These expressions show that when $q < 1$, imposing the PPC has a downside: it forces M to either set a high fee and thereby not make any sales with probability $1 - q$, or set a lower fee that ensures the seller always participates. If instead M does not impose PPC, the seller always participates and M always makes sales even if it maintains the highest possible fee $f = v - c$, provided switching costs are not too low in the baseline state. This means that it is now possible for imposing PPC to be a dominated strategy. We confirm this with the same uniform distribution for G as in the baseline model.

Proposition 4. *Suppose $G(s) = \frac{s}{\mu}$ for $s \in [0, \mu]$. The marketplace prefers not to impose a PPC if and only if $q < \frac{1}{2}$ and $\mu > \frac{v - c}{2}$. Otherwise, it prefers to impose a PPC.*

The downside of imposing a PPC is that it forces the seller to choose between participating or not, given the seller loses its ability to shift some transactions to its direct channel when the fee turns out to be too high. By contrast, without a PPC the seller always participates and can induce demand for M in both states, even at high fees.

To see how this logic plays out, consider the case in which $1 - q$ is sufficiently high so that M prefers to set $f = v - c$ under a PPC, so that the seller only accepts the offer in the no-switching state. In this case, M can do strictly better without a PPC by also setting

$f = v - c$: this extracts the same profit as under PPC in the no-switching state, but obtains additional profit in the baseline state provided not all buyers in that state switch to purchase directly when $f = v - c$ (this is true whenever the switching costs in the baseline are high enough, i.e., $\mu > \frac{v-c}{2}$). If q is higher but still less than one-half, the logic extends to the case when M prefers to attract the seller in both states under PPC, given to do so requires M set its fee sufficiently low.

Another reason M may prefer not to impose a PPC is if it risks being found anti-competitive by the relevant authorities, something which applies to large and dominant marketplaces.¹³

For these reasons, marketplaces may prefer to discipline sellers less explicitly, which is something the next section explores.

5.5 Competing sellers and steering

Thus far we have assumed the marketplace attracts a single seller. As discussed in the baseline setting, this could capture the idea that the marketplace has many different sellers, each of which is in a different product or service category, so they can be treated separately. In this section we explore whether a marketplace would want to host a second competing seller and the impact seller competition has on leakage. In doing so, we will also consider the possibility that the marketplace can steer buyers towards the seller that induces less leakage. For example, CoachUp, a marketplace connecting fitness enthusiasts with private coaches for many different sports, provides preferential treatment in its listings to coaches that conduct more repeat transactions through the marketplace.

To analyze seller competition and steering in a tractable way, we suppose there are only two sellers, one of which is the same as in the benchmark case (the high-quality seller), and the other whose product is valued at u , where $c \leq u \leq v$ (the low-quality seller). The reason to allow for vertically differentiated sellers is to make the steering decision less trivial. If $u = v$, so the two sellers are identical, then M never loses anything by steering towards the seller that induces less leakage, thereby inducing the sellers to not undercut in the direct channel at all. As a result, M can charge its maximum fee (i.e. $f^* = v - c$) and obtain maximum profits. However, when $u < v$, if M charges $f^* = v - c$, then it may lose the ability to credibly prevent the high-quality seller from inducing leakage if the low-quality seller find it unprofitable to sell on M at such a high fee. The model is otherwise the same as the baseline setting.

¹³As analyzed in Edelman and Wright (2015), the use of PPCs by large marketplaces raises competition and regulatory concerns.

We first treat the case when M cannot steer buyers, before exploring the implications of M being able to steer buyers to one of the sellers by hiding the other. We will use the usual asymmetric Bertrand tie-breaking rule throughout: when buyers are indifferent between buying from the high-quality and low-quality seller, they choose the high-quality seller.

5.5.1 Competition without steering

Even without steering, allowing for two competing but vertically differentiated sellers makes the analysis of leakage considerably more complicated. Fundamentally, this is because competition between sellers in the direct market can lead to more leakage than a single seller (the high-quality one) would optimally want to induce. Despite the added complications, we are able to prove the following results.¹⁴

Proposition 5. *Suppose there are two competing sellers, a high-quality seller with value v and a low-quality seller with value $u \leq v$, and switching costs are distributed according to $G(s) = \frac{s}{\mu}$ with $\bar{s} = \mu$. In equilibrium, the high-quality seller always makes all sales on both channels. The marketplace’s profit with two competing sellers is always weakly lower than the marketplace’s profit with the high-quality seller only (i.e. the baseline), and indeed is weakly decreasing in u .*

The proposition shows that in the absence of steering, M is always weakly worse off with competing sellers. Indeed, M ’s profits are the same as in the case with just the high-quality seller only when $u - c \leq \frac{v-c}{2}$ and $\mu \geq 2(u - c)$, i.e. when the low-quality seller is a sufficiently weak competitor and the switching costs are high enough so that leakage is not too serious of an issue. Otherwise, introducing competition always hurts M —and so does making the low-quality seller more competitive, i.e. increasing u . This runs counter to the usual intuition that marketplaces benefit from introducing more competition among their sellers in the absence of any innovation incentives.

To understand this result, note that for the range of M ’s fee where the low-quality seller constrains the pricing of the high-quality seller (i.e. when $f \leq u - c$), competition pins down the high-quality seller’s prices ($p_m^h = c + f + v - u$ and $p_d^h = c + v - u$), thus increasing the difference between its price on M and its direct price relative to the case when the high-quality seller is a monopolist (recall from the baseline that was only $p_m - p_d = \min\{\frac{f}{2}, \mu\}$). This “involuntary” leakage makes M strictly worse off. Otherwise, the low-quality seller

¹⁴The proof in the appendix contains the full equilibrium characterization, including M ’s optimal fee and profits. Using those expressions, it is easily seen that M ’s optimal fee is weakly increasing and its profit is increasing in the switching cost parameter μ , consistent with Proposition 1 for the baseline setting.

doesn't constrain the high-quality seller's price, which is the case when the low-quality seller is a sufficiently weak competitor and the switching costs are high enough.

By the same logic, when u decreases, the competitive pressure exerted by the low-quality seller is lower, so the high-quality seller has more market power, implying it can adjust prices in a way that induces less leakage, which benefits M . When u is sufficiently low and the switching costs are high enough, the presence of the low-quality seller becomes irrelevant and the outcome is the same as that with the high-quality seller only.

The bottomline is that without any other instrument available to the marketplace, competition among sellers exacerbates the leakage issue. By pinning down seller prices on and off the marketplace, competition among sellers reduces the marketplace's ability to influence each individual seller's prices (via its transaction fee) to induce less leakage.

5.5.2 Vertically differentiated sellers and steering

We now extend the above analysis to the case M can steer buyers by only showing one of the two sellers depending on their respective prices. In order to explore steering, we naturally focus on the interpretation of our model in which buyers only know about the sellers if they discover them first on M (otherwise the analysis is the same as in the previous subsection). Once a seller is shown on M , buyers become aware of it, and so also know the seller's price in the direct channel. The reliance on M for discoverability means M can leverage competition between sellers to discipline them from undercutting too much in the direct channel.¹⁵

Specifically, given f and a set of seller prices, M 's objective is simply to maximize the number of transactions on M . This means it will show the seller with the lowest $p_m - p_d$, i.e. which induces the least amount of leakage, subject to the constraint that buyers obtain non-negative surplus purchasing from the seller shown by M . This is the key difference relative to the previous setting with no steering: here, the two sellers are competing to minimize the difference between their direct price and their price on M , as opposed to competing in price on each channel.

To be precise, we assume that M makes its steering decision in the following way, given prices (p_m^l, p_d^l) set by the low-quality seller and (p_m^h, p_d^h) set by the high-quality seller:

- If both sellers are offering non-negative surplus to buyers on M (i.e. if $p_m^l \leq u$ and $p_m^h \leq v$), then show the seller with the lowest difference between price on M and direct price. If both sellers have the same difference (i.e. if $p_m^l - p_d^l = p_m^h - p_d^h$), then show the high-quality seller.

¹⁵Unlike the case of the price-parity clause analyzed in Section 5.4, here M cannot commit to hide a seller if it induces some leakage. Rather, M decides which seller(s) to show based on the prices they set. As a result, there may be leakage in equilibrium as we show below.

- If only one seller is offering non-negative surplus to buyers on M , then show that seller.
- If neither seller is offering non-negative surplus to buyers on M (i.e. if $p_m^l > u$ and $p_m^h > v$), then show the high-quality seller.

In the first case above, M is indifferent between showing either seller. Breaking the tie in favor of the high-quality seller does not have any impact on M 's profit in the equilibrium of the full game.

In the third case above, M is indifferent between showing either seller or showing neither, because in all cases it makes zero profits—no buyers are willing to purchase on M from either seller. This tie-breaking assumption does have an impact on the overall equilibrium, by ensuring that M will never set $f > v - c$ when f is already high enough that the low-quality seller cannot make non-negative total profits and so is irrelevant. This treatment is consistent with the baseline setting with a monopoly seller in which M never sets $f > v - c$.¹⁶

The need to rely on M for being discovered and M 's ability to steer also imply that here sellers may be willing to incur losses on M , which are then recouped in the direct channel, provided the total profit is non-negative. For example, if $f > u - c$, then the low-quality seller loses money on sales via M , but is willing to compete to be recommended as long as there exists $p_d^l \leq u$ such that

$$(p_d^l - c) G(u - p_d^l) + (u - c - f) (1 - G(u - p_d^l)) \geq 0.$$

In this case, the low-quality seller maximizes its chances of being shown by setting $p_m^l = u$ and setting p_d^l as high as possible subject to the non-negative profit constraint above. The derivation of the equilibrium will have to account for this subsidization strategy. Of course, this strategy no longer works if f is sufficiently large. Then the low-quality seller cannot make non-negative total profits, in which case it sets $p_m^l > u$ and is effectively irrelevant, i.e. the high-quality seller acts as a monopolist since it knows that it will get recommended by M no matter what (given our assumptions above).

We can fully characterize the equilibrium once we make our standard distributional assumption on switching costs. Relegating the details of the equilibrium characterization to the appendix, we obtain the following proposition.

Proposition 6. *Suppose there are two competing sellers, a high-quality seller with value v and a low-quality seller with value $u \leq v$, switching costs are distributed according to*

¹⁶Alternatively, we could assume that when neither seller is offering non-negative surplus to buyers that purchase via the marketplace, M does not show either seller. In Online Appendix E, we redo the analysis in this section with this alternative assumption and show Proposition 6 continues to hold, even though the precise expressions for the optimal fee and M 's profit change somewhat.

$G(s) = \frac{s}{\mu}$ with $\bar{s} = \mu$, and the marketplace can steer buyers to either seller. In equilibrium, the high-quality seller always makes all sales on both channels. The marketplace's profit is always weakly higher than both the profit with two competing sellers and no steering, and the profit with the high-quality seller only (i.e. the baseline). Moreover, the marketplace's profit is weakly increasing in u .

Proposition 6 shows that M 's profit is always weakly higher with steering. Note, however, that this is not entirely obvious a priori, since M cannot commit to steer when setting f .¹⁷ The reason for this result is that sellers compete to get favored by M , which means they have an incentive to reduce leakage, which always benefits M . We show in the proof of Proposition 6 that, fixing u , if the switching cost μ is high enough, there is always positive leakage in equilibrium. However, when μ is low enough, there is no leakage. This is in contrast to the case without steering, where there is always positive leakage in equilibrium.

Taken together with Proposition 5, Proposition 6 implies steering is crucial for the introduction of a competing seller to benefit M .¹⁸ Indeed, recall that without steering, M 's profit was weakly decreasing in the competitiveness of the low-quality seller (measured by u), and therefore it was lower with competing sellers than with a monopoly seller. By contrast, with steering, M 's profit is now weakly increasing in the competitiveness of the low-quality seller, so M always benefits from its presence (relative to the baseline monopoly seller case).

To better understand why the effect of seller competition on M 's profit changes with steering, it is useful to consider two limit cases. When $u \rightarrow c$, the low-quality seller becomes irrelevant, so the optimal fee f^* and M 's profit Π^* are the same as without competition, and this would be true with or without steering. On the other hand, when $u \rightarrow v$, i.e. the two sellers' products become perfect substitutes, both sellers end up setting the same price on and off M in an effort to get recommended, so there is no leakage, and M optimally sets $f^* = v - c$ to extract the entire surplus. This last result contrasts to the case without steering, in which the equilibrium prices are $p_m = c + f$ and $p_d = c$ when $u \rightarrow v$, so there is positive leakage still.

The bottomline is that adding the ability to steer buyers among sellers allows the marketplace to reverse the negative impact that competition among sellers had on leakage in

¹⁷Hagiu et al. (2022) show how a platform can benefit from the ability to steer consumers towards its own product in a setting where consumers can switch and buy directly if the price on the platform is too high. The threat of steering relaxes the leakage constraint on the platform's commission, thus increasing its profit. Our setting here is different since steering is among different (vertically differentiated) third-party sellers rather than between a seller and the platform's own product, and steering arises in equilibrium in our setting.

¹⁸In Online Appendix F, we confirm this also holds in a (simpler) variant of our setup with competing sellers, in which the low-quality seller is only active on M , i.e. does not have a direct channel.

the absence of steering. With steering, the marketplace is able to benefit from increased competition among sellers while keeping leakage in check.

6 Managerial implications

While our analysis has focused on the solutions a platform can employ to deal with leakage, it is useful to start by asking what conditions make leakage more likely to be a concern. These can be thought of as factors that determine how high are switching costs (e.g. the parameter μ that we focused on):

a) Propensity of repeat transactions with the same counterparty

Repeated transactions between the same counterparties not only increase the amount of transaction fees the parties can save by completing transactions off the marketplace, but they also make it possible to get to know one another, build trust, and so be more willing to transact directly. Marketplaces for babysitters (e.g. Care.com), dog walkers (e.g. Wag!), coaches (e.g. CoachUp), tutors (e.g. Preply), home cleaners (e.g. Handy), and gardeners (e.g. Lawn Love) all grapple with this problem.

b) Ability to clearly specify transaction scope on the marketplace

For some services, such as fixing a car or resolving electrical or plumbing issues, the parties have to meet and communicate before they settle on what the transaction will involve (e.g. inspect a problem and give a quote for the work required). In such cases, leakage becomes a lot easier as the parties share information, gain trust and can make payments directly before the marketplace is ever in a position to try to charge a fee for the transaction.

c) In-person vs. remote/online transactions

Other things equal, leakage is harder to avoid when transactions are conducted in-person (TaskRabbit) than online (Fiverr). The reasons are obvious: in-person meetings make it easier for the parties to share information, gain trust, and coordinate payment in cash, or via one of the many available peer-to-peer payment apps (e.g. PayPal, Venmo or WeChat).

After determining the severity of the leakage problem, companies and managers can prioritize the various solutions to it based on our analysis.

In general, providing transaction benefits beyond discovery should be the first and main priority. As we have shown, such benefits are particularly effective when switching costs to transacting directly are either very low or very high, i.e. when leakage is either very easy or very difficult—this can be determined using the criteria laid out above. When leakage is very easy, providing lots of transaction benefits is crucial for marketplaces to be able to extract any transaction fees. When leakage is very difficult, marketplaces should also invest a lot in transaction benefits because the marketplace can almost fully extract the sellers' margin,

which is increased by transaction benefits. By contrast, when the likelihood of leakage is moderate, marketplaces' incentives to invest in transaction benefits are lower: the moderate switching costs protect them sufficiently from leakage so that they can slack off investing, and the margin extracted from sellers is not large enough to provide strong investment incentives. Finally, in all cases, in addition to offering transaction benefits, marketplaces can and should also add any features that increase buyer switching costs to the relevant direct channels (e.g. loyalty programs, group discounts for multiple buyers as pioneered by Pinduoduo).

Second, marketplaces should encourage seller competition, provided their steering of buyers is sufficiently effective to make competition reduce leakage. Specifically, marketplaces should steer buyers towards sellers with direct prices that do not induce too much, if any, leakage. In settings where direct prices are not observed but consumers make repeat transactions, this means steering towards sellers with a high number of repeat transactions conducted through the marketplace. In our model, we have assumed steering can perfectly conceal sellers which are not shown from buyers. In reality, however, steering is not perfect. So marketplaces need to determine how effective their steering efforts are in influencing buyers' awareness and shopping behavior, which can be done via A/B testing. The more effective steering is, the closer we are to the situation in Section 5.5, where competition leads to less leakage and higher marketplace profits. In these situations, marketplaces should make design decisions that increase the competitive intensity among sellers (e.g. emphasizing prices when showing sellers' offerings to buyers). If on the other hand steering is not very effective, then more intense competition leads to more leakage and lower marketplace profits, as in Section 5.5. In these situations, marketplaces are better off reducing the competitive intensity among sellers (e.g. by emphasizing non-price factors).

That being said, in practice there are other reasons why a marketplace may still want to allow some seller competition, even if steering is not possible. For instance, rival sellers may produce horizontally differentiated varieties of the same product; the increased variety may induce more buyers to come to the marketplace in the first place. In these situations, our finding implies marketplaces should take into account that increased head-to-head competition among sellers will exacerbate leakage when weighing up how much seller competition they wish to allow.

Third, limiting communication between participants can sometimes be effective, but only up to a point. By limiting communication, a platform makes it more difficult for its buyers and sellers to coordinate on taking transactions off the platform, but it also makes it more difficult for buyers to evaluate the desirability of the sellers' products. With this tradeoff in mind, limiting communication is effective in combatting leakage either when the resulting loss of information is very low (so sellers don't have to worry much about buyers being

uncertain about their products' desirability), or when the loss of information is very high. The latter possibility may sound surprising, but it arises because in this case, by limiting communication, marketplaces force sellers to lower their on-platform prices enough that even buyers who are uncertain about product desirability end up buying. In other words, limiting communication works either when it does not have a strong effect on buyer information about sellers' products, or when it has such a strong effect that sellers have no choice but to account for it by lowering their prices. Needless to say, in practice, limiting communication between buyers and sellers can backfire by leading to buyer and seller resentment (and therefore even more leakage), so marketplaces should only consider it if the scope for leakage (based on the factors discussed above) is very high.

Fourth, while imposing price parity would in principle seem like the cleanest way to eliminate leakage, it has a downside in forcing sellers to make an all-or-nothing choice: either they are all-in and conduct all of their transactions on the marketplace (they cannot use prices to shift transactions to their direct channel if they accept the contract) or they do not participate on the marketplace at all (if they reject the contract). If each type of seller knows better than the marketplace the propensity of its buyers to switch to buy directly, it can be better for the marketplace not to force a seller's hand since doing so risks losing sellers as a result (or requires the marketplace to set a much lower fee to keep all sellers on board). This is especially true where the scope for leakage is anyway not very strong.

Fifth, where the scope for leakage is high, and the above strategies are not very effective in dealing with it, marketplaces should consider changing their business model to one based on referral fees instead of transaction fees (as Capterra, Thumbtack and others have done). This is a more drastic measure, which has the advantage of sidestepping leakage altogether, but at the cost of giving up the ability to extract more value from a seller that has particularly high buyer demand (i.e. high likelihood of buyers purchasing or high dollar spend). Less drastically, marketplaces can use both referral and transaction fees, something they should consider when the propensity for leakage is neither extremely high or extremely low. In this case, an added benefit of using both fees is that the referral fee ensures participating sellers have a sufficiently high buyer demand, which in turn means the transaction fee can also be higher. Referral fees are preferable to fixed access fees because they at least take into account the uncertainty over the number of potential buyers that are exposed to the seller via the marketplace. However, if referral fees are not feasible (e.g. because it is difficult to meter/monitor how many buyers are exposed to a given seller), then marketplaces can consider relying mainly on fixed access fees.

Finally, we should note an important pitfall that fast-growing marketplaces (and their investors) need to be aware of when evaluating the risk of leakage. Initially, when a market-

place is growing fast and users on either side are mainly discovering new transaction partners on the other side, rather than doing repeat transactions with existing partners, leakage does not appear to be a big issue and may lead to complacency, e.g. under-investment in the features designed to minimize leakage incentives. Once users have settled down on a few counterparts they transact with often, then the leakage problem can become a lot more serious. Consequently, marketplaces should try to think about getting the right strategies in place for combatting leakage from the very beginning.

7 Future directions

Some of our results suggest natural avenues for empirical researchers to pursue. We have provided predictions regarding a marketplace's choice of strategy to combat leakage (investment in transaction benefits, whether communication is limited, the type of fees used, whether price parity clauses are adopted, whether competition between sellers is encouraged), depending on various underlying factors (the value of transactions, the level of switching costs, the importance of uncertainty in buyer demand, the ability to steer buyers among competing sellers and the degree of substitutability between these sellers' products)—some of these predictions can and should be tested.

Another interesting avenue to explore (theoretically) is the idea that leakage could also create an adverse selection problem on marketplaces. If consumers prefer to buy repeatedly from the same seller once their product or service has been proven to be good, and if sellers have a capacity constraint, then high-quality sellers will be more likely to leave the marketplace after they have built a large-enough base of buyers. Consequently, the marketplace will be left with a disproportionate fraction of low-quality sellers, at which point buyers will stop using the marketplace. This was exactly the problem that caused the demise of Homejoy, a marketplace for home cleaners: the most popular cleaners left the marketplace once they had amassed a sufficient number of customers that they could serve regularly. It would be interesting to explore whether adverse selection created by leakage can make it optimal for marketplaces to adopt a more radical change in business model, namely to stop being marketplaces altogether, and provide the product or service themselves instead.

One can also extend our analysis to competing marketplaces. To the extent that fees are pinned down by competition between marketplaces and sellers do not multihome across marketplaces (or if they do, they can set separate direct prices to target buyers from each marketplace), one could apply our equilibrium analysis of seller pricing in the subgame for a given fee to obtain the effects of leakage. However, the way in which competition determines marketplace fees, and the resulting effects on the choice of different strategies to address

leakage will be more complicated than in our monopoly marketplace setting. This would be an interesting direction that future research should explore.

Finally, ours is a static framework, which means we have not explicitly modeled the possibility of return customers, which give a marketplace the option to adjust transaction fees based on the number of times buyers return to purchase from the same seller on the marketplace. For instance, CoachUp charges coaches transaction fees based on a sliding scale depending on the number of sessions completed with the same athlete, as does Upwork with respect to the value of the work, and Preply with respect to the value of tutoring done within a month. It would be interesting to explore the effectiveness of such pricing strategies in dealing with leakage.

8 Appendix

We include proofs of propositions not established in the text.

8.1 Proof of Lemma 1

If M were to set $f > v - c$, S would make a loss selling through M , and as a result would simply set some price $p_m > v$, so that it makes no sales on M .¹⁹ This in turn implies M would make zero profits in this case. So we must have $f \leq v - c$. And it must be that $f > 0$, otherwise M makes no profits, which cannot be optimal.

Second, given $f \leq v - c$, we must have $p_m = v$. If $p_m > v$, then S benefits (weakly) from switching to $p_m = v$, so that buying from S through M now gives buyers the same net payoff as the outside option (zero). Indeed, buyers who were buying from S 's direct channel will keep doing so. Meanwhile, if the buyers with the highest switching cost $s = \bar{s}$ were not buying in the direct channel, then there is now a positive measure of buyers who were not buying anything from S at $p_m > v$ and who will now buy at $p_m = v$. If instead $p_m < v$, then S 's profits are

$$(p_d - c)G(p_m - p_d) + (p_m - c - f)(1 - G(p_m - p_d)),$$

where $G(p_m - p_d) = 0$ whenever $p_m \leq p_d$. In this case S can increase profits by slightly increasing p_m and p_d by the same amount.

And third, S sets $p_d < v$. Indeed, given $p_m = v$ and $f > 0$, S does better by shifting from $p_d \geq v$ to $p_d = v - \varepsilon$, where $\varepsilon < f$: this shifts buyers with low enough switching cost

¹⁹Note that if we take the interpretation of our model in which S needs to be present on M in order to be discovered by buyers, setting $p_m > v$ ensures no buyer purchases from S through M , yet S is discovered so buyers can purchase from it in its direct channel.

from M to the direct channel, where S 's margin is higher by $f - \varepsilon$ (it no longer pays the fee on those buyers).

8.2 Proof of Proposition 1

Given (5) and noting second-order conditions hold for any $f > 0$ and $\mu > 0$, we have that M solves

$$\arg \max_f \left\{ f \left(1 - \frac{f}{2\mu} \right) \right\} = \mu < 2\mu.$$

Taking into account that $f \leq v - c$, this implies the level of f^* and Π^* given in Proposition 1.

First, note that Π^* is always increasing in μ . To determine the direct price, note that if $\mu \leq v - c$, then $f^* = \mu \leq 2\mu$, so in this case using (4) we get $p_d^* = v - \frac{\mu}{2}$. If $\mu \geq v - c$, then $f^* = v - c \leq \mu \leq 2\mu$, so in this case using (4) we get $p_d^* = v - \frac{v-c}{2}$. Combining these two results implies p_d^* in Proposition 1. Clearly, p_d^* is strictly decreasing in μ when $\mu < v - c$, but for $\mu \geq v - c$, p_d^* is constant in μ .

The equilibrium extent of leakage is given by $\frac{f^*}{2\mu}$. Given $f^* = \min\{\mu, v - c\}$, the extent of leakage is $\min\left\{\frac{1}{2}, \frac{v-c}{2\mu}\right\}$. This is initially constant, and then decreasing in μ .

8.3 Proof of Proposition 2

With $G(s) = \frac{s}{\mu}$ and $K(b) = \frac{k}{2}b^2$, we have

$$p_d^*(f) = \begin{cases} v - \mu & \text{if } f \geq b + 2\mu \\ v - \frac{1}{2}(f - b) & \text{if } b \leq f \leq b + 2\mu \end{cases}.$$

This implies that M 's profit is

$$\Pi^* = \max_{\substack{b \geq 0 \\ b \leq f \leq v - c + b}} \Pi(b, f),$$

where

$$\Pi(b, f) = \begin{cases} -\frac{kb^2}{2} & \text{if } f \geq b + 2\mu \\ f \left(1 - \frac{1}{2\mu}(f - b) \right) - \frac{kb^2}{2} & \text{if } b \leq f \leq b + 2\mu \\ b - \frac{kb^2}{2} & \text{if } f = b \end{cases}.$$

Recall that we also have the constraint $f \leq v + b - c$, since at any higher fee S will not

want to list on M . The FOC for the middle expression implies

$$f^* = \mu + \frac{b}{2} < 2\mu + b.$$

Thus, we have

$$\Pi(b) = \begin{cases} b - \frac{kb^2}{2} & \text{if } b \geq 2\mu \\ \frac{(2\mu+b)^2}{8\mu} - \frac{kb^2}{2} & \text{if } \max\{2\mu - 2(v-c), 0\} \leq b \leq 2\mu \\ (v-c+b)\left(1 - \frac{v-c}{2\mu}\right) - \frac{kb^2}{2} & \text{if } 0 \leq b \leq \max\{2\mu - 2(v-c), 0\} \end{cases},$$

which we can optimize over b .

Suppose first $\mu \leq v - c$. Then

$$\Pi(b) = \begin{cases} b - \frac{kb^2}{2} & \text{if } b \geq 2\mu \\ \frac{(2\mu+b)^2}{8\mu} - \frac{kb^2}{2} & \text{if } 0 \leq b \leq 2\mu \end{cases},$$

so

$$\Pi'(b) = \begin{cases} 1 - kb & \text{if } b \geq 2\mu \\ \frac{1}{2} - \left(k - \frac{1}{4\mu}\right)b & \text{if } 0 \leq b \leq 2\mu \end{cases}.$$

If $k > \frac{1}{4\mu}$, then $\Pi''(b) < 0$ everywhere, so there is a unique maximizer given by

$$b^* = \begin{cases} \frac{1}{k} & \text{if } \frac{1}{4\mu} \leq k \leq \frac{1}{2\mu} \\ \frac{1}{2k - \frac{1}{2\mu}} & \text{if } k \geq \frac{1}{2\mu} \end{cases},$$

which leads to profits

$$\Pi^* = \begin{cases} \frac{1}{2k} & \text{if } \frac{1}{4\mu} \leq k \leq \frac{1}{2\mu} \\ \frac{\mu k}{2k - \frac{1}{2\mu}} & \text{if } k \geq \frac{1}{2\mu} \end{cases}.$$

If $k < \frac{1}{4\mu}$, then $\Pi'(b)$ is increasing in b over $b \in [0, 2\mu]$, and decreasing in b for $b \geq 2\mu$. Since $\Pi'(0) = \frac{1}{2} > 0$, the profit-maximizing choice of b is $b^* = \frac{1}{k}$. The bottomline for the case $\mu \leq v - c$:

$$b^* = \begin{cases} \frac{1}{k} & \text{if } k \leq \frac{1}{2\mu} \\ \frac{1}{2k - \frac{1}{2\mu}} & \text{if } k \geq \frac{1}{2\mu} \end{cases},$$

Now suppose $\mu > v - c$. We have

$$\Pi'(b) = \begin{cases} 1 - kb & \text{if } b \geq 2\mu \\ \frac{1}{2} - \left(k - \frac{1}{4\mu}\right)b & \text{if } 2\mu - 2(v - c) \leq b \leq 2\mu \\ 1 - \frac{v-c}{2\mu} - kb & \text{if } 0 \leq b \leq 2\mu - 2(v - c) \end{cases}$$

Note that $\Pi'(b)$ is continuous in b .

Here too, there are two cases. If $k \geq \frac{1}{4\mu}$, then $\Pi'(b)$ is decreasing for all b , so $\Pi'(b) = 0$ has a unique solution b^* , which is the maximizer of $\Pi(b)$. The profit-maximizing b is

$$b^* = \begin{cases} \frac{1}{k} & \text{if } \frac{1}{4\mu} \leq k \leq \frac{1}{2\mu} \\ \frac{1}{2k - \frac{1}{2\mu}} & \text{if } \frac{1}{2\mu} \leq k \leq \frac{2\mu - (v-c)}{4\mu(\mu - (v-c))} \\ \frac{1}{k} - \frac{v-c}{2k\mu} & \text{if } k \geq \frac{2\mu - (v-c)}{4\mu(\mu - (v-c))} \end{cases}$$

and the maximum profit is

$$\Pi^* = \begin{cases} \frac{1}{2k} & \text{if } \frac{1}{4\mu} \leq k \leq \frac{1}{2\mu} \\ \frac{\mu k}{2k - \frac{1}{2\mu}} & \text{if } \frac{1}{2\mu} \leq k \leq \frac{2\mu - (v-c)}{4\mu(\mu - (v-c))} \\ (v - c) \left(1 - \frac{v-c}{2\mu}\right) + \frac{1}{2k} \left(1 - \frac{v-c}{2\mu}\right)^2 & \text{if } k \geq \frac{2\mu - (v-c)}{4\mu(\mu - (v-c))} \end{cases}$$

If $k < \frac{1}{4\mu}$, then $\Pi'(b)$ is decreasing for $b \in [0, 2\mu - 2(v - c)]$, increasing for $b \in [2\mu - 2(v - c), 2\mu]$, and decreasing for $b \geq 2\mu$. And we have

$$\begin{aligned} \Pi'(2\mu - 2(v - c)) &= 1 - \frac{1}{2\mu}(v - c) - k(2\mu - 2(v - c)) \\ &> 1 - \frac{1}{2\mu}(v - c) - \frac{1}{4\mu}(2\mu - 2(v - c)) \\ &= \frac{1}{2} > 0 \end{aligned}$$

So in this case the profit maximizing solution is $b^* = \frac{1}{k}$.

The bottomline for the case $\mu > v - c$:

$$b^* = \begin{cases} \frac{1}{k} & \text{if } k \leq \frac{1}{2\mu} \\ \frac{1}{2k - \frac{1}{2\mu}} & \text{if } \frac{1}{2\mu} \leq k \leq \frac{2\mu - (v-c)}{4\mu(\mu - (v-c))} \\ \frac{1}{k} - \frac{v-c}{2k\mu} & \text{if } k \geq \frac{2\mu - (v-c)}{4\mu(\mu - (v-c))} \end{cases}$$

If $\mu > (v - c)$, then it is straightforward to verify that $\frac{1}{2\mu} \leq k \leq \frac{2\mu - (v-c)}{4\mu(\mu - (v-c))}$ is equivalent to

$\frac{1}{2k} \leq \mu \leq \bar{\mu}$, where

$$\bar{\mu} = \frac{v-c}{2} + \frac{1}{4k} + \sqrt{\left(\frac{v-c}{2}\right)^2 + \frac{1}{16k^2}}.$$

And $k \geq \frac{2\mu-(v-c)}{4\mu(\mu-(v-c))}$ is equivalent to $\mu \geq \bar{\mu}$. Note that

$$\bar{\mu} > \max \left\{ v-c, \frac{1}{2k} \right\}.$$

Thus, we can write the optimal solution as a function of μ as follows:

- if $\mu \leq v-c$, then

$$b^* = \begin{cases} \frac{1}{k} & \text{if } \mu \leq \frac{1}{2k} \\ \frac{1}{2k-\frac{1}{2\mu}} & \text{if } \mu \geq \frac{1}{2k} \end{cases},$$

- if $\mu > v-c$, then

$$b^* = \begin{cases} \frac{1}{k} & \text{if } \mu \leq \frac{1}{2k} \\ \frac{1}{2k-\frac{1}{2\mu}} & \text{if } \frac{1}{2k} \leq \mu \leq \bar{\mu} \\ \frac{1}{k} - \frac{v-c}{2k\mu} & \text{if } \mu \geq \bar{\mu} \end{cases}$$

Distinguishing the cases $v-c \leq \frac{1}{2k}$ and $v-c \geq \frac{1}{2k}$, it is easily seen that all these cases collapse to

$$b^* = \begin{cases} \frac{1}{k} & \text{if } \mu \leq \frac{1}{2k} \\ \frac{1}{2k-\frac{1}{2\mu}} & \text{if } \frac{1}{2k} \leq \mu \leq \bar{\mu} \\ \frac{1}{k} - \frac{v-c}{2k\mu} & \text{if } \mu \geq \bar{\mu} \end{cases}.$$

This implies

$$f^* = \begin{cases} b^* & \text{if } \mu \leq \frac{1}{2k} \\ \mu + \frac{b^*}{2} & \text{if } \frac{1}{2k} \leq \mu \leq \bar{\mu} \\ v + b^* - c & \text{if } \mu \geq \bar{\mu} \end{cases}$$

$$p_d^* = \begin{cases} v & \text{if } \mu \leq \frac{1}{2k} \\ v - \frac{\mu(2k\mu-1)}{4k\mu-1} & \text{if } \frac{1}{2k} \leq \mu \leq \bar{\mu} \\ \frac{v+c}{2} & \text{if } \mu \geq \bar{\mu} \end{cases}$$

$$\Pi^* = \begin{cases} \frac{1}{2k} & \text{if } \mu \leq \frac{1}{2k} \\ \frac{\mu k}{2k-\frac{1}{2\mu}} & \text{if } \frac{1}{2k} \leq \mu \leq \bar{\mu} \\ (v-c) \left(1 - \frac{v-c}{2\mu}\right) + \frac{1}{2k} \left(1 - \frac{v-c}{2\mu}\right)^2 & \text{if } \mu \geq \bar{\mu} \end{cases}.$$

8.4 Proof of Proposition 3

If $qv < c$, then $\Pi_L(\eta) < 0$ for all $\eta \in [0, 1]$, so M chooses option 1 for all $\eta \in [0, 1]$.

Suppose now $qv > c$. We have

$$\Pi_H(0) = 0 < \Pi_L(0) = qv - c.$$

and

$$\lim_{\eta \rightarrow 1} \Pi_H(\eta) > 0 > \lim_{\eta \rightarrow 1} \Pi_L(\eta) = -\infty.$$

Furthermore, Π_H is obviously increasing in η and Π_L is decreasing in η :

$$\frac{d\Pi_L}{d\eta} = -\frac{(1-q)qv}{(1-\eta)^2} \left((2-\eta)q\eta + 2(1-\eta)^2 \right) + c(1-q),$$

which is negative under $qv > c$ since $(2-\eta)q\eta + 2(1-\eta)^2 > (1-\eta)^2$.

Thus, when $qv > c$, there exists a unique $\eta^* \in (0, 1)$ such that M prefers option 1 ($\Pi_H(\eta) \geq \Pi_L(\eta)$) when $\eta \geq \eta^*$ and option 2 ($\Pi_H(\eta) \leq \Pi_L(\eta)$) when $\eta \leq \eta^*$, where

$$\eta^* = \frac{qv(2-q) - c - q\sqrt{(1-q)v(v-c)}}{qv(3(1-q) + q^2) - c}.$$

This means M 's profits with communication banned are decreasing and then increasing in η , with the minimum occurring at $\eta = \eta^*$. When $\eta = 0$, profits are $qv - c$, and when $\eta = 1$, profits are $q(v - c)$.

We now need to compare these profits to M 's profit when it allows communication, which is $q\Pi^*$. First note that M prefers to ban communication when $\eta > \frac{\Pi^*}{v-c}$, regardless of q . Indeed, $\eta > \frac{\Pi^*}{v-c}$ implies $\Pi_H(\eta) > q\Pi^*$ for all $q > 0$. Second, if $v - \frac{c}{q} \leq \Pi^*$, then $\Pi_L(\eta) \leq q\Pi^*$ for all η , so M prefers to ban communication if and only if $\eta > \frac{\Pi^*}{v-c}$. (Note this includes the case in which $qv - c < 0$ noted at the start.) And third, if $v - \frac{c}{q} > \Pi^*$, then M also prefers to ban communication when $\eta < \eta_L$, where $\eta_L > 0$ is uniquely defined by $\Pi_L(\eta_L) = q\Pi^*$. In this case, if $\eta^* > \frac{\Pi^*}{v-c}$, then M prefers to ban communication for all η and q . Since $\lim_{q \rightarrow 1} \eta^* = 1$ and $qv > c$ holds if q is close enough to one, this implies M always prefers to ban communication if q is close enough to one.

8.5 Proofs for the section on price parity clauses

First we prove the claim that imposing a PPC is always better for M when $q = 1$, regardless of $G(\cdot)$. Indeed, with $q = 1$, the marketplace's profits are

$$\Pi_{PPC}^* = v - c - \max_{c \leq p_d \leq v} \{(p_d - c) G(v - p_d)\}.$$

and

$$\Pi^* = \max_{f \leq v-c} \{f(1 - qG(v - p_d^*(f)))\}.$$

Denote M 's optimal fee without a PPC by f^* . We have

$$\begin{aligned} \max_{c \leq p_d \leq v} \{(p_d - c) G(v - p_d)\} &\leq \max_{p_d \leq v} \{(p_d - c) G(v - p_d) + (v - c - f^*)(1 - G(v - p_d))\} \\ &= (p_d^*(f^*) - c) G(v - p_d^*(f^*)) + (v - c - f^*)(1 - G(v - p_d^*(f^*))) \end{aligned}$$

and

$$v - c \geq (p_d^*(f^*) - c) G(v - p_d^*(f^*)) + (v - c)(1 - G(v - p_d^*(f^*))).$$

Taking the difference between these last two inequalities, we obtain $\Pi_{PPC}^* \geq \Pi^*$.

Next, we prove Proposition 4. Suppose $G(s) = \frac{s}{\mu}$. If $q \geq \frac{1}{2}$, then

$$\begin{aligned} \Pi_{PPC}^* &= \max \left\{ v - c - \begin{cases} \frac{(v-c)^2}{4\mu} & \text{if } \mu \geq \frac{v-c}{2} \\ v - c - \mu & \text{if } \mu \leq \frac{v-c}{2} \end{cases}, (1-q)(v-c) \right\} \\ \Pi^* &= \begin{cases} \frac{\mu}{2q} & \text{if } \mu \leq q(v-c) \\ (v-c) \left(1 - \frac{q}{2\mu}(v-c)\right) & \text{if } \mu \geq q(v-c) \end{cases}. \end{aligned}$$

And it is then easily verified that we have $\Pi_{PPC}^* \geq \Pi^*$ by looking in turn at the regions $\mu \leq \frac{v-c}{2}$, $\frac{v-c}{2} \leq \mu \leq q(v-c)$, and $\mu \geq q(v-c)$.

If $q < \frac{1}{2}$, then

$$\begin{aligned} \Pi_{PPC}^* &= \max \left\{ v - c - \begin{cases} \frac{(v-c)^2}{4\mu} & \text{if } \mu \geq \frac{v-c}{2} \\ v - c - \mu & \text{if } \mu \leq \frac{v-c}{2} \end{cases}, (1-q)(v-c) \right\} \\ \Pi^* &= (v-c) \left(1 - q \min \left\{ \frac{v-c}{2\mu}, 1 \right\}\right). \end{aligned}$$

If $\mu \leq \frac{v-c}{2}$, then

$$\Pi_{PPC}^* = \max \{\mu, (1-q)(v-c)\} = (1-q)(v-c) = \Pi^*.$$

If $\mu > \frac{v-c}{2}$, then

$$\Pi^* = (v-c) - 2q \frac{(v-c)^2}{4\mu}$$

$$\Pi_{PPC}^* = \max \left\{ v-c - \frac{(v-c)^2}{4\mu}, (1-q)(v-c) \right\}.$$

Clearly we have

$$(v-c) - 2q \frac{(v-c)^2}{4\mu} > v-c - \frac{(v-c)^2}{4\mu}$$

because $q < \frac{1}{2}$, and

$$(v-c) - 2q \frac{(v-c)^2}{4\mu} > (1-q)(v-c)$$

because $\frac{v-c}{2} < \mu$. Thus, we have $\Pi^* > \Pi_{PPC}^*$ iff $q < \frac{1}{2}$ and $\mu > \frac{v-c}{2}$.

8.6 Proof of Proposition 5

We begin by proving the following lemma.

Lemma 2. *If $u-c \leq \frac{v-c}{2}$, then M 's optimal fee and resulting profits are:*

$$f^* = \begin{cases} \frac{\mu}{2} & \text{if } \mu \leq (4-2\sqrt{2})(u-c) \\ 2(u-c) & \text{if } (4-2\sqrt{2})(u-c) < \mu \leq 2(u-c) \\ \mu & \text{if } 2(u-c) < \mu \leq v-c \\ v-c & \text{if } \mu > v-c \end{cases}$$

$$\Pi^* = \begin{cases} \frac{\mu}{4} & \text{if } \mu \leq (4-2\sqrt{2})(u-c) \\ 2(u-c) \left(1 - \frac{u-c}{\mu}\right) & \text{if } (4-2\sqrt{2})(u-c) \leq \mu \leq 2(u-c) \\ \frac{\mu}{2} & \text{if } 2(u-c) \leq \mu \leq v-c \\ (v-c) \left(1 - \frac{v-c}{2\mu}\right) & \text{if } \mu \geq v-c \end{cases}.$$

If $\frac{v-c}{2} \leq u-c \leq v-c$, then M 's optimal fee and resulting profits are:

$$f^* = \begin{cases} \frac{\mu}{2} & \text{if } \mu \leq 2(v-c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right) \\ v-c & \text{if } \mu > 2(v-c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right) \end{cases}$$

$$\Pi^* = \begin{cases} \frac{\mu}{4} & \text{if } \mu \leq 2(v-c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right) \\ (v-c) \left(1 - \frac{u-c}{\mu}\right) & \text{if } \mu \geq 2(v-c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right) \end{cases}$$

Proof of Lemma 2. In equilibrium, it must be that the high-quality seller (S_h) makes

all sales on both channels. Indeed, suppose the low-quality seller (S_l) makes sales at a price $p_d^l \in [c, u]$ in the direct channel. Then S_h can profitably deviate by setting $p_d^h = p_d^l + v - u \in [c + v - u, v]$ and keeping p_m^h unchanged. This will not affect its profit on M since it doesn't induce any more buyers to switch to buy directly, and allows it to make additional profit from the direct channel. And similarly if S_l makes sales on M at a price $p_m^l \in [c + f, u]$. This means there is no way for S_l to make profitable sales anywhere in equilibrium. Specifically, it can't be that it makes a loss in one channel since it would need to make profits in the other channel, which is not possible. Thus, S_h makes all sales.

Given f , S_l 's prices are $p_d^l = c$ and $p_m^l = c + f$. Note that when $f > u - c$, we have $p_m^l > u$, so S_l becomes irrelevant on M in that case.

In equilibrium, we must have $f \leq v - c$. Otherwise, if $f > v - c$, then S_h would set $p_m^h > v$ to avoid selling at a loss on M (and S_l would set $p_m^l > u$), resulting in zero profits for M .

Next, for S_h , we can restrict attention to $p_d^h \leq p_m^h$ without loss of generality. Indeed, if $p_d^h > p_m^h$, then no buyer would buy from S_h in the direct channel, so S_h can do at least as well with $p_d^h \leq p_m^h$. And we must have $p_m^h \leq \min\{c + f + v - u, v\}$ and $p_d^h \leq \min\{c + v - u, v\} = c + v - u$, otherwise S_l could deviate and make some positive profits. S_h 's profits are

$$(p_d^h - c) G(p_m^h - p_d^h) + (p_m^h - c - f) (1 - G(p_m^h - p_d^h)).$$

For this to be an equilibrium, we must have $p_m^h = \min\{c + f + v - u, v\}$ or $p_d^h = c + v - u$, otherwise S_h could increase profits by raising both prices by the same very small amount.

Suppose the binding constraint is $p_d^h = c + v - u$ and we have $p_m^h < \min\{c + f + v - u, v\}$. Then the margin that S_h makes on direct channel sales is $v - u$, while the margin on sales through M is $p_m^h - c - f$, which is strictly less than $v - u$, because $p_m^h - c - f < \min\{v - u, v - c - f\}$. This means that S_h can strictly increase profits by slightly increasing p_m^h , which shifts sales to the higher margin channel. Thus, in equilibrium, we must have $p_m^h = \min\{c + f + v - u, v\}$.

There are then two main cases.

1. If $f \leq u - c$, then $p_m^h = c + f + v - u$ and S_h solves

$$\max_{p_d^h \leq c + v - u} \left\{ (p_d^h - c) \frac{\min\{c + f + v - u - p_d^h, \mu\}}{\mu} + (v - u) \left(\frac{\mu - \min\{c + f + v - u - p_d^h, \mu\}}{\mu} \right) \right\}.$$

It is easily verified that the solution is always $p_d^h = c + v - u$, which implies that in this

case M 's profits are

$$\Pi(f) = f(1 - G(p_m^h - p_d^h)) = f\left(1 - \frac{\min\{f, \mu\}}{\mu}\right).$$

2. If $f > u - c$, then $p_m^h = v$ and S_h solves

$$\max_{p_d^h \leq c+v-u} \left\{ (p_d^h - c) \frac{\min\{v - p_d^h, \mu\}}{\mu} + (v - c - f) \left(\frac{\mu - \min\{v - p_d^h, \mu\}}{\mu} \right) \right\}.$$

There are two subcases:

- If $\mu \leq u - c$, then S_h optimally sets $p_d^h = c + v - u$, resulting in profits $v - u$ for S_h and zero for M .
- If $\mu \geq u - c$, then S_h optimally sets

$$p_d^h(f) = \begin{cases} c + v - u & \text{if } u - c < f \leq 2(u - c) \\ v - \frac{f}{2} & \text{if } 2(u - c) \leq f \leq 2\mu \\ v - \mu & \text{if } f \geq 2\mu \end{cases},$$

resulting in profits for M of

$$\Pi(f) = \begin{cases} f\left(1 - \frac{u-c}{\mu}\right) & \text{if } u - c < f \leq 2(u - c) \\ f\left(1 - \frac{f}{2\mu}\right) & \text{if } 2(u - c) \leq f \leq 2\mu \\ 0 & \text{if } f \geq 2\mu \end{cases}.$$

We now proceed to solve for M 's optimal choice of f .

Suppose $\mu \leq u - c$. Then M must set $f \leq u - c$ to obtain positive profits, so it solves $\max_{f \leq u-c} \left\{ f\left(1 - \frac{f}{\mu}\right) \right\}$. This implies $f^* = \frac{\mu}{2} < u - c$ and $\Pi^* = \frac{\mu}{4}$.

Now consider $\mu > u - c$. There are three relevant choices for M to obtain positive profits when $\mu > u - c$: (i) M can set $f \leq u - c$ and obtain $f\left(1 - \frac{f}{\mu}\right)$, so the optimal fee on this interval is $f = \min\{\frac{\mu}{2}, u - c\}$; (ii) M can set $u - c \leq f \leq \min\{2(u - c), v - c\}$ and obtain $f\left(1 - \frac{u-c}{\mu}\right)$, so the optimal fee on this interval is $f = \min\{2(u - c), v - c\}$; (iii) M can set $2(u - c) \leq f \leq \min\{2\mu, v - c\}$ and obtain $f\left(1 - \frac{f}{2\mu}\right)$, which is only possible when $2(u - c) \leq \min\{v - c, 2\mu\}$.

We need to distinguish two cases for $\mu > u - c$.

1. First suppose $v - c \leq 2(u - c)$. And suppose $\mu \leq 2(u - c)$. Then M chooses between (i) $\frac{\mu}{4}$ (obtained by setting $f = \frac{\mu}{2}$) and (ii) $(v - c)\left(1 - \frac{u-c}{\mu}\right)$ (obtained by setting

$f = v - c$). Comparing (i) and (ii), M will set $f^* = \frac{\mu}{2}$ if $\mu < 2(v - c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right)$ and otherwise will set $f^* = v - c$. Note given u lies between c and v , it can be verified that

$$u - c \leq 2(v - c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right) \leq 2(u - c).$$

Next suppose $\mu > 2(u - c)$. Then M chooses between (i) $(u - c) \left(1 - \frac{u-c}{\mu}\right)$ and (ii) $(v - c) \left(1 - \frac{u-c}{\mu}\right)$, and clearly will choose the latter so $f^* = v - c$ in this case too. Thus, we have confirmed the results in the Proposition when $\mu > u - c$ and $v - c \leq 2(u - c)$.

2. Second, suppose $v - c > 2(u - c)$. We can first consider the case $\mu \leq 2(u - c)$. So M can choose between (i) $\frac{\mu}{4}$ and (ii) $2(u - c) \left(1 - \frac{u-c}{\mu}\right)$. (Note M 's profit $f \left(1 - \frac{f}{2\mu}\right)$ under (iii) is decreasing in f for $f \geq 2(u - c)$ under these assumptions, which is why M can ignore option (iii)). Comparing (i) and (ii), M will set $f^* = \frac{\mu}{2}$ if $\mu < 2(2 - \sqrt{2})(u - c)$ and otherwise will set $f^* = 2(u - c)$. Next suppose $\mu > 2(u - c)$. Then M chooses between (i) $(u - c) \left(1 - \frac{u-c}{\mu}\right)$, (ii) $2(u - c) \left(1 - \frac{u-c}{\mu}\right)$ and (iii) $f^* = \min\{\mu, v - c\}$ with M obtaining either $\frac{\mu}{2}$ and $(v - c) \left(1 - \frac{v-c}{2\mu}\right)$ respectively. Clearly (ii) dominates (i). If $2(u - c) < \mu < v - c$, then $f^* = \mu$ under option (iii) so M obtains $\frac{\mu}{2}$ which is better than option (ii) given $\mu > 2(u - c)$. Finally, if $\mu > v - c$, then $f^* = v - c$ under option (iii) so M obtains $(v - c) \left(1 - \frac{v-c}{2\mu}\right)$ which is better than option (ii) given that $f \left(1 - \frac{f}{2\mu}\right)$ is increasing in f at $f = v - c$ when $\mu > v - c$.

Thus, we have proven each of the different cases for f^* and Π^* given in the text of the lemma.

■

We can now use the expressions of f^* and Π^* provided in the Lemma 2 to prove Proposition 5. To determine the effect of u on M 's profits, suppose first $u - c \geq \frac{v-c}{2}$. Note that $2(v - c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right)$ is decreasing in u . If $\mu < 2(v - c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right)$, then a slight increase in u leaves Π^* unchanged. If $\mu \geq 2(v - c) \left(1 - \sqrt{\frac{v-u}{v-c}}\right)$, then a slight increase in u decreases Π^* . Now suppose $u - c \leq \frac{v-c}{2}$. If $\mu \leq (4 - 2\sqrt{2})(u - c)$ or $\mu > 2(u - c)$, then a slight increase in u leaves Π^* unchanged. If $(4 - 2\sqrt{2})(u - c) < \mu \leq 2(u - c)$, then a slight increase in u decreases Π^* because $2(u - c) \left(1 - \frac{u-c}{\mu}\right)$ is decreasing in $(u - c)$ when $\mu \leq 2(u - c)$. Thus, in all cases Π^* is weakly decreasing in u . And it is easily seen that Π^* converges to the expression of M 's profit with a monopoly high-quality seller given by (5) when $u \rightarrow c$.

8.7 Proof of Proposition 6

We start by proving the following lemma.

Lemma 3. *If $u - c \leq \frac{v-c}{2}$, then M 's optimal fee and resulting profits are*

$$\begin{aligned}
 f^* &= \begin{cases} u - c & \text{if } \mu \leq 2(u - c) \\ \mu & \text{if } 2(u - c) < \mu \leq v - c \\ v - c & \text{if } \mu > v - c \end{cases} \\
 \Pi^* &= \begin{cases} u - c & \text{if } \mu \leq 2(u - c) \\ \frac{\mu}{2} & \text{if } 2(u - c) \leq \mu \leq v - c \\ (v - c) \left(1 - \frac{v-c}{2\mu}\right) & \text{if } \mu \geq v - c \end{cases} . \quad (8)
 \end{aligned}$$

If $\frac{v-c}{2} \leq u - c \leq v - c$, then M 's optimal fee and resulting profits are

$$\begin{aligned}
 f^* &= \begin{cases} u - c & \text{if } \mu \leq \frac{(v-c)^2}{2(v-u)} \\ v - c & \text{if } \mu > \frac{(v-c)^2}{2(v-u)} \end{cases} \\
 \Pi^* &= \begin{cases} u - c & \text{if } \mu \leq \frac{(v-c)^2}{2(v-u)} \\ (v - c) \left(1 - \frac{v-c}{2\mu}\right) & \text{if } \mu \geq \frac{(v-c)^2}{2(v-u)} \end{cases} \quad (9)
 \end{aligned}$$

Proof of Lemma 3. As explained in the main text, given f and seller prices, M recommends the seller that induces the least amount of leakage (i.e. with the lowest non-negative difference between price on M and direct price), subject to offering non-negative utility to buyers that buy via M . We define $\bar{p}_d^l(f)$ as the direct price that maximizes the low-quality seller's chance to get recommended while allowing it to make non-negative total profits:

$$\bar{p}_d^l(f) = \max_{p_d \leq u} \{p_d\} \quad (p_d - c) \frac{\min\{u - p_d, \mu\}}{\mu} + (u - c - f) \left(1 - \frac{\min\{u - p_d, \mu\}}{\mu}\right) \geq 0$$

Indeed, the low-quality seller's (i.e. S_l 's) best chance to get recommended is when it sets $p_m^l = u$ and p_d^l as close as possible to u , while still making non-negative profits. We define $\bar{p}_d^h(f)$ in the same way for the high-quality seller (S_h):

$$\bar{p}_d^h(f) = \max_{p_d \leq v} \{p_d\} \quad (p_d - c) \frac{\min\{v - p_d, \mu\}}{\mu} + (v - c - f) \left(1 - \frac{\min\{v - p_d, \mu\}}{\mu}\right) \geq 0$$

First, we prove that²⁰

$$\bar{p}_d^l(f) = \begin{cases} u & \text{if } f \leq u - c \\ u - \frac{f - \sqrt{f^2 - 4\mu(f - (u - c))}}{2} & \text{if } \mu \leq u - c \leq f \text{ or } \\ & \mu > u - c \text{ and } u - c \leq f \leq 2\mu \left(1 - \sqrt{1 - \frac{u - c}{\mu}}\right) \\ -\infty & \text{if } \mu > u - c \text{ and } f > 2\mu \left(1 - \sqrt{1 - \frac{u - c}{\mu}}\right) \end{cases}$$

and

$$\bar{p}_d^h(f) = \begin{cases} v & \text{if } f \leq v - c \\ v - \frac{f - \sqrt{f^2 - 4\mu(f - (v - c))}}{2} & \text{if } \mu \leq v - c \leq f \text{ or } \\ & \mu > v - c \text{ and } v - c \leq f \leq 2\mu \left(1 - \sqrt{1 - \frac{v - c}{\mu}}\right) \\ -\infty & \text{if } \mu > v - c \text{ and } f > 2\mu \left(1 - \sqrt{1 - \frac{v - c}{\mu}}\right). \end{cases}$$

Focus on S_l first. If $f \leq u - c$, then it is easily seen that $\bar{p}_d^l(f) = u$. If $\mu \leq u - c$, then $\bar{p}_d^l(f)$ is well-defined for all $f \geq u - c$, because for $p_d = u - \mu$ we have

$$(p_d - c) \frac{\min\{u - p_d, \mu\}}{\mu} + (u - c - f) \left(1 - \frac{\min\{u - p_d, \mu\}}{\mu}\right) = u - c - \mu \geq 0.$$

In this case

$$\bar{p}_d^l(f) = u - \frac{f - \sqrt{f^2 - 4\mu(f - (u - c))}}{2}. \quad (10)$$

Indeed, $\mu \leq u - c$ implies $f^2 \geq 4\mu(f - (u - c))$ for all f and $\bar{p}_d^l(f) \geq u - \mu$.

If $\mu > u - c$, then $\bar{p}_d^l(f)$ is well-defined (i.e. has a finite value) iff $f^2 \geq 4\mu(f - (u - c))$ and $f \leq 2\mu$, which is equivalent to

$$0 \leq f \leq 2\mu \left(1 - \sqrt{1 - \frac{u - c}{\mu}}\right).$$

Thus, $\bar{p}_d^l(f)$ is well-defined iff $f \leq u - c$ or $\mu \leq u - c \leq f$ or $\mu > u - c$ and $u - c \leq f \leq 2\mu \left(1 - \sqrt{1 - \frac{u - c}{\mu}}\right)$. Indeed, $u - c < 2\mu \left(1 - \sqrt{1 - \frac{u - c}{\mu}}\right)$ when $\mu > u - c$. Otherwise, S_l cannot make non-negative profits, so $\bar{p}_d^l(f) = -\infty$. When it is well-defined, $\bar{p}_d^l(f)$ is given by (10) above.

The proof for the expression of $\bar{p}_d^h(f)$ is the same, replacing u by v .

Next, we show that in equilibrium, S_h makes all sales. Indeed, from the expressions of

²⁰It is easily verified that $2\mu \left(1 - \sqrt{1 - \frac{u - c}{\mu}}\right) > u - c$ whenever $\mu > u - c$ and $2\mu \left(1 - \sqrt{1 - \frac{v - c}{\mu}}\right) > v - c$ whenever $\mu > v - c$.

$\bar{p}_d^l(f)$ and $\bar{p}_d^h(f)$ above, if $f \leq u - c$, then both are willing to make all sales via M , so each of them sets the same price on and off M , meaning S_h makes all sales (M breaks ties in favor of S_h).

Suppose $\mu \leq u - c \leq f$ or $\mu > u - c$ and $u - c \leq f \leq 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right)$. Then

$$u - \bar{p}_d^l(f) = \frac{f - \sqrt{f^2 - 4\mu(f - (u - c))}}{2}.$$

Note that in this case we cannot have $\mu > v - c$ and $f > 2\mu \left(1 - \sqrt{1 - \frac{v-c}{\mu}}\right)$, because $v - c \geq u - c$. Thus $v - \bar{p}_d^h(f)$ is either equal to zero or to $\frac{f - \sqrt{f^2 - 4\mu(f - (v - c))}}{2}$. And in both cases we have $v - \bar{p}_d^h(f) \leq u - \bar{p}_d^l(f)$, so S_h can offer a lower difference in prices and will make all sales.

Finally, if $\mu > u - c$ and $f > 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right)$, then $u - \bar{p}_d^l(f) = +\infty$, so S_l cannot make non-negative profits by selling via M , and will set $p_m^l > u$. If $v - \bar{p}_d^h(f)$ is finite, then S_h will choose p_d^h to maximize profits ignoring the presence of S_l , which is irrelevant. If in addition $f > v - c$, then S_h will set $p_m^h > v$ and

$$p_d^h = \arg \max_{p_d \leq v} \left\{ (p_d - c) \min \left\{ \frac{v - p_d}{\mu}, 1 \right\} \right\}.$$

Indeed, this is profit-maximizing for S_h , given that we have assumed M recommends S_h when $p_m^l > u$ and $p_m^h > v$. So M makes zero profits in this case. Finally, if $v - \bar{p}_d^h(f) = u - \bar{p}_d^l(f) = +\infty$, then neither seller can make non-negative profits with positive sales via M , so once again $p_m^l > u$ and $p_m^h > v$, so M makes zero profits. Thus, if $u - \bar{p}_d^l(f) = +\infty$, then we must have $f \leq v - c$ for M to make positive profits. And in this case S_h will make all sales once again.

Given f , S_l 's prices are

$$(p_m^l, p_d^l) = \begin{cases} (u, \bar{p}_d^l(f)) & \text{if } \bar{p}_d^l(f) \text{ is well-defined} \\ (u + \varepsilon, -\infty) & \text{if } \bar{p}_d^l(f) = -\infty \end{cases},$$

where ε is an arbitrary positive number. In other words, S_l becomes irrelevant when $\bar{p}_d^l(f) = -\infty$.

There are therefore two cases:

1. If $\mu > u - c$ and $f > 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right)$, then $\bar{p}_d^l(f) = -\infty$, which means S_l has no chance of making non-negative total profits if it sells anything via M . This implies

it might as well price at $p_d^l = p_m^l > u$, which makes it irrelevant.²¹ In this case, if $f \leq v - c$, then S_h does best by setting $p_m^h = v$ and $p_d^h = p_d^*(f) = v - \min\{\frac{f}{2}, \mu\}$, so it gets recommended by M , makes positive profits, and M 's profit is $f \left(1 - \min\left\{\frac{f}{2\mu}, 1\right\}\right)$ as in the baseline model. If $f > v - c$, then S_h sets $p_m^h > v$ to avoid making sales at a loss on M (as in the baseline model), so M makes zero profits.

2. If $\mu \leq u - c$ or $\mu > u - c$ and $0 \leq f \leq 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right)$, then $\bar{p}_d^l(f)$ exists. In this case, S_l sets $p_m^l = u$ and $p_d^l = \bar{p}_d^l(f)$, while S_h sets $p_m^h = v$ and p_d^h to maximize profits subject to $v - p_d^h \leq u - \bar{p}_d^l(f)$ (so that it is recommended by M), i.e.

$$\begin{aligned} p_d^h &= \arg \max_{p_d \geq v - \frac{f - \sqrt{f^2 - 4\mu(f - (u-c))}}{2}} \left\{ (p_d - c) \frac{\min\{v - p_d, \mu\}}{\mu} + (v - c - f) \left(1 - \frac{\min\{v - p_d, \mu\}}{\mu}\right) \right\} \\ &= v - \frac{f - \sqrt{f^2 - 4\mu(f - (u-c))}}{2}, \end{aligned}$$

where the last equality follows because $v - \frac{f - \sqrt{f^2 - 4\mu(f - (u-c))}}{2} \geq \max\{v - \frac{f}{2}, v - \mu\}$ under the conditions that define this case. Also, we know that at these prices, S_h must make non-negative profits because if $\bar{p}_d^l(f)$ is well-defined, then so is $\bar{p}_d^h(f)$. This implies M 's profit in this case is

$$f \left(1 - \frac{f - \sqrt{f^2 - 4\mu(f - (u-c))}}{2\mu}\right).$$

If M sets $f \leq u - c$, then $\bar{p}_d^l(f) = u$ and $\bar{p}_d^h(f) = v$. In this case, S_l 's best chance to be recommended and make non-negative profits is to set $p_d^l = p_m^l = u$. The best response of S_h is then to set $p_d^h = p_m^h = v$, which ensures that it is recommended by M (given M breaks ties in favor of S_h). This leads all buyers to purchase from S_h on M , so M 's profits are equal to f . As a result, M does best in this range to set $f = u - c$, yielding a profit equal to $u - c$.

We can therefore restrict attention to $f \geq u - c$.

Suppose $\mu \leq u - c$, so we are in the second case above. The derivative of M 's profit with respect to f is

$$\frac{-\left(2\mu - f + \sqrt{f^2 - 4\mu(f - (u-c))}\right) \left(f - \sqrt{f^2 - 4\mu(f - (u-c))}\right)}{2\mu\sqrt{f^2 - 4\mu(f - (u-c))}},$$

²¹Thus, we are implicitly making the assumption (standard in Bertrand competition games) that S_l does not play a dominated strategy off the equilibrium path (e.g. $p_d^l = p_m^l = u$, which would yield negative profits if M were to recommend it).

which is non-positive because $f > \sqrt{f^2 - 4\mu(f - (u - c))}$ and $u - c \geq \mu$ imply $2\mu - f + \sqrt{f^2 - 4\mu(f - (u - c))} \geq 0$. This means M wants to set f as low as possible subject to $f \geq u - c$. Thus, we have proven that when $\mu \leq u - c$, the optimal solution for M is to set $f^* = u - c$, resulting in $p_d^h = p_m^h = v$, no leakage and $\Pi^* = u - c$.

Now suppose $\mu > u - c$.

- If $u - c \leq f \leq 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right)$, then we are once again in the second case above. And once again $2\mu - f + \sqrt{f^2 - 4\mu(f - (u - c))} \geq 0$ because $2\mu - f \geq 0$, so M 's best option on this range is to set $f = u - c$, resulting in profit $u - c$.
- If $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \geq v - c$, then M makes zero profits for all $f > 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right)$ (see the first case above).
- If $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \leq v - c$, then M can set f such that $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) < f \leq v - c$, so that we are in the first case above. S_l is irrelevant, and M 's profit is $f \left(1 - \min \left\{ \frac{f}{2\mu}, 1 \right\}\right)$. Setting $f > v - c$ in this case results in zero profits for M .

Thus, if $\mu > u - c$ and $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \geq v - c$, then M 's optimal solution is $f^* = u - c$, resulting in profit $u - c$.

Note that $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \geq v - c$ is equivalent to $\mu \geq \frac{v-c}{2}$ and $\mu \leq \frac{(v-c)^2}{4(v-u)}$. This is possible iff $\frac{v-c}{2} \leq \frac{(v-c)^2}{4(v-u)}$, i.e. iff $u - c \geq \frac{v-c}{2}$. So, assuming $u - c \geq \frac{v-c}{2}$, we have that $\mu > u - c$ and $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \geq v - c$ is equivalent to $u - c < \mu \leq \frac{(v-c)^2}{4(v-u)}$. Indeed, $u - c < \frac{(v-c)^2}{4(v-u)}$ whenever $u < v$.

Finally, if $\mu > u - c$ and $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \leq v - c$, then M chooses between $u - c$ and

$$2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) < f \leq v - c \left\{ f \left(1 - \min \left\{ \frac{f}{2\mu}, 1 \right\}\right) \right\} = 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) < f \leq v - c \left\{ f \left(1 - \frac{f}{2\mu}\right) \right\}.$$

Note that $\mu > u - c$ and $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \leq v - c$ is equivalent to $\mu > u - c$ and $(\mu \leq \frac{v-c}{2}$ or $\mu \geq \frac{(v-c)^2}{4(v-u)})$. Furthermore,

$$2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \sqrt{1 - \frac{u-c}{\mu}} < u - c$$

for all $\mu > u - c$ and

$$(v - c) \left(1 - \frac{v - c}{2\mu}\right) \leq u - c \iff \mu \leq \frac{(v - c)^2}{2(v - u)}.$$

We can therefore distinguish the following possibilities when $\mu > u - c$ and $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \leq v - c$:

- If $u - c < \frac{v-c}{2}$, then $\frac{(v-c)^2}{4(v-u)} < \frac{v-c}{2}$ so $\mu > u - c$ and $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \leq v - c$ is equivalent to $\mu > u - c$. In this case, it is easily verified that

$$2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) < f \left\{ f \left(1 - \frac{f}{2\mu}\right) \right\} = \begin{cases} 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \sqrt{1 - \frac{u-c}{\mu}} & \text{if } u - c < \mu \leq \frac{4(u-c)}{3} \\ \frac{\mu}{2} & \text{if } \frac{4(u-c)}{3} \leq \mu \leq v - c \\ (v - c) \left(1 - \frac{v-c}{2\mu}\right) & \text{if } \mu \geq v - c \end{cases},$$

so:

- if $u - c < \mu \leq 2(u - c)$, then M 's optimal solution is $f^* = u - c$, yielding $\Pi^* = u - c$
- if $2(u - c) \leq \mu \leq v - c$, then M 's optimal solution is $f^* = \mu$, yielding $\Pi^* = \frac{\mu}{2}$
- if $\mu \geq v - c$, then M 's optimal solution is $f^* = v - c$, yielding $\Pi^* = (v - c) \left(1 - \frac{v-c}{2\mu}\right)$
- If $u - c \geq \frac{v-c}{2}$, then $\mu > u - c$ and $2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \leq v - c$ is equivalent to $\mu \geq \frac{(v-c)^2}{4(v-u)}$. And $u - c \geq \frac{v-c}{2}$ implies

$$\frac{(v - c)^2}{4(v - u)} > \frac{4(u - c)}{3} \Leftrightarrow \frac{4(u - c)}{3} > v - c.$$

In this case:

- if $\frac{v-c}{2} \leq u - c \leq \frac{3(v-c)}{4}$, then

$$2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) < f \left\{ f \left(1 - \frac{f}{2\mu}\right) \right\} = \begin{cases} 2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) \sqrt{1 - \frac{u-c}{\mu}} & \text{if } u - c < \mu \leq \frac{4(u-c)}{3} \\ \frac{\mu}{2} & \text{if } \frac{4(u-c)}{3} \leq \mu \leq v - c \\ (v - c) \left(1 - \frac{v-c}{2\mu}\right) & \text{if } \mu \geq v - c \end{cases},$$

so:

- * if $u - c \leq \mu \leq \frac{(v-c)^2}{2(v-u)}$, then M 's optimal solution is $f^* = u - c$, yielding $\Pi^* = u - c$
- * if $\mu \geq \frac{(v-c)^2}{2(v-u)}$, then M 's optimal solution is $f^* = v - c$, yielding $\Pi^* = (v - c) \left(1 - \frac{v-c}{2\mu}\right)$
- if $\frac{3(v-c)}{4} < u - c \leq v - c$, then $\frac{(v-c)^2}{4(v-u)} > v - c$ and therefore

$$2\mu \left(1 - \sqrt{1 - \frac{u-c}{\mu}}\right) < f \left\{ f \left(1 - \frac{f}{2\mu}\right) \right\} = (v - c) \left(1 - \frac{v - c}{2\mu}\right),$$

so once again:

- * if $u - c \leq \mu \leq \frac{(v-c)^2}{2(v-u)}$, then M 's optimal solution is $f^* = u - c$, yielding $\Pi^* = u - c$
- * if $\mu \geq \frac{(v-c)^2}{2(v-u)}$, then M 's optimal solution is $f^* = v - c$, yielding $\Pi^* = (v - c) \left(1 - \frac{v-c}{2\mu}\right)$

We have thus proven the expressions of f^* and Π^* given in the text of lemma 3. ■

We can now use these expressions to prove Proposition 6.

To determine the effect of u on M 's profits, suppose first $u - c > \frac{v-c}{2}$. Note that $\frac{(v-c)^2}{2(v-u)}$ is increasing in u . If $\mu \leq \frac{(v-c)^2}{2(v-u)}$, then a slight increase in u increases Π^* . If $\mu > \frac{(v-c)^2}{2(v-u)}$, then a slight increase in u leaves Π^* unchanged. Now suppose $u - c \leq \frac{v-c}{2}$. If $\mu \leq 2(u - c)$, then a slight increase in u increases Π^* . If $\mu > 2(u - c)$, then a slight increase in u leaves Π^* unchanged. Thus, in all cases Π^* is weakly increasing in u . And it is easily seen that Π^* converges to the expression of M 's profit with a monopoly high-quality seller given by (5) when $u \rightarrow c$. Since M 's profit with steering is weakly increasing in u , while M 's profit without steering is weakly decreasing in u , and both profits converge to M 's profit with a monopoly high-quality seller when $u \rightarrow c$, we can conclude that M 's profit with steering is everywhere weakly higher than the profit without steering.

Finally, it is easily seen from the expressions of M 's optimal fee and profits (8) and (9) that in both cases there is no leakage when μ is small and positive leakage when μ is large.

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