INSTITUTIONAL INVESTMENT, COMMON OWNERSHIP AND ANTITRUST

BY XAVIER VIVES [1]

I. INTRODUCTION

The growth of institutional investment, owning up to 80 percent of the United States ("U.S.") stock market by 2010 when in 1950 it was about 7 percent, has been formidable. This rise of diversified institutional investment, where passive funds – such as index funds – play an increasingly important role, has raised antitrust concerns, mostly in the U.S. One reason is that the proportion of U.S. public firms in the hands of institutional investors, which at the same time hold large blocks of other firms in the *same* industry, has grown dramatically (from under 10 percent in 1980 to about 60 percent in 2010).[2] The result is that top shareholders of the main companies in quite a few industries are funds such as BlackRock, Vanguard, Fidelity or State Street and the likes. The concern is that managers may internalize the interests of these common stakeholders in their competitive industry decisions. Even though passive investors, in particular index funds, have no possibility to exercise control with an "exit," they do have a "voice." There is some evidence in the airline and banking sectors that common ownership may affect prices and customer conditions.[3]

II. ANTITRUST CONCERNS IN THE U.S. AND IN THE EU

In Canada and the U.S., minority shareholdings are scrutinized under the prevailing merger control rules. More specifically, in the U.S. they are examined with reference to the Clayton Act and the Hart-Scott-Rodino Act. It should be noted that there is an exception to antitrust scrutiny if the participation is "solely for investment" purposes. However, horizontal ownership arrangements can be challenged if they substantially lessen competition according to the antitrust statutes.[4] There are calls

1 Xavier Vives, IESE Business School.

2 He & Huang, *Product Market Competition in a World of Cross-Ownership: Evidence from Institutional Blockholdings* (2017), forthcoming REV. FIN. STUDIES.

3 Azar, Schmalz & Tecu study the U.S. airline industry, and find that ticket prices are about 10 percent higher on the average route than they would be if strategy decisions were made without regard to the investors' overlapping ownership holdings. Azar, Schmalz & Tecu, *Anti-competitive Effects of Common Ownership,* Ross School of Business Working Paper 1235 (2015). Similar results are obtained for the banking industry. Azar, Raina & Schmalz, *Ultimate Ownership and Bank Competition* (2016), available at: https://ssrn.com/abstract=2710252.

4 Section 7 of the Clayton Act prohibits acquisitions (of any part) of a company's stock that "may" substantially lessen competition either by (a) enabling the acquirer to manipulate, directly or indirectly, prices or output or by (b) reducing its own incentives to compete. The "substantive" passive investor provision states that the prohibition does "not apply to persons purchasing such stock solely for investment and not using the same by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition." According the Hart-Scott-Rodino Act and the regulation of the Federal Trade Commission and the Department of Justice, (properly defined) passive investors acquiring no more than 15 percent of the stock of a corporation have a filing exemption. Salop & O'Brien, *Competitive Effects of Partial Ownership: Financial Interest and Corporate Control,* ANTITRUST L.J. 559-614 (2000), and Elhauge, *Horizontal Shareholding,* HARVARD L.REV. 1267-1317 (2016).

in the U.S. to limit common ownership in oligopolistic industries in exchange for a safe harbor provision from enforcement of the Clayton Act.[5]

In Europe the concern arose mainly because of some notorious minority shareholdings operations such as Ryanair's acquisition of Aer Lingus's stock. The proposed *Ryanair/Aer Lingus* merger was notified to the European Commission ("EC") but when the EC prohibited the merger, Ryanair acquired a close to 30 percent stake in its competitor.[6] The problem for European antitrust authorities is that currently, the EC can consider the effects on competition only of pre-existing minority shareholdings in the context of a notified merger (and where the merging firms each have stakes in a third firm). The EC is considering to extend the scope of the Merger Regulation to be able to intervene under a "targeted transparency" system under which the EC and its Member States must be notified of potentially harmful acquisitions. Included in this category would be acquisitions of a minority shareholding — in a competitor or vertically related company — when either the acquired shareholding amounts to 20 percent or ranges between 5 percent and 20 percent but allows the acquirer "a de-facto blocking minority, a seat on the board of directors, or access to commercially sensitive information of the target."[7] However, during the 2016 ABA spring meeting, Commissioner Vestager announced that it was too early to announce a policy direction and that "the amount of red tape and the administrative burden it would put on businesses would not give you the benefit of a more competitive market."[8] Vestager noted that "only a handful of [minority acquisition] deals are likely to raise issues" and expressed a need to proceed cautiously, i.e. only once there is "compelling evidence that the system could work at European level – without creating a lot of complexity."[9]

III. INDUSTRIAL ORGANIZATION ANALYSIS

In order to gain some perspective on the issue at hand, it is worth recalling the, once upon a time dominant, structure-conduct-performance ("SCP") paradigm in Industrial Organization which is associated to Bain. According to the market power hypothesis developed by this approach, firms in concentrated markets protected by barriers to entry earn high price/cost margins and profits. It was found in cross section studies of industries that the relation between concentration (measured for example by the Herfindahl-Hirschman Index ("HHI")) and profitability was statistically weak and the estimated effect of concentration usually small. This approach was criticized by the Chicago School for not modeling the conduct of firms. The apparent correlation between concentration and profitability could be due to the fact, according to the efficiency hypothesis postulated by Demsetz, that large firms are more efficient, command larger price/cost margins and earn higher profits, and therefore concentration and industry profitability go together.

We can formulate a revised market power hypothesis as follows: Firms in markets with high levels of common/overlapping ownership earn high price/cost margins and profits because of reduced competitive pressure. Preliminary evidence consistent with such hypothesis, using a modified HHI which accounts for overlapping ownership, is in the work of Azar, Schmalz and co-authors for airlines and banking, as well as for a cross section of industries in the work of Banal-Estanol, Seldeslachts and Vives.[10] However, continuing with the analogy with the SCP paradigm, we can also formulate a revised efficiency hypothesis as follows: High levels of common/overlapping ownership and efficiency are associated because common/overlapping ownership improves information sharing, firm collaboration, corporate governance (because of, among other reasons, the presence of economies of scale in information production and monitoring an industry), and induces managers to reduce cost and/or

5 Posner, Scott Morton & Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors* (2017), available at https://papers.ssrn.com/abstract=2872754.

6 In August 2013, the UK CC ordered Ryanair to sell its 29.8 percent stake in Aer Lingus down to 5 percent. Another notable case is the Renault-Nissan alliance, whereby Renault owns 44.3 percent of Nissan, which in turn owns 15 percent of Renault. In the U.S., other cases have also attracted attention: Northwest Airlines purchased 14 percent of the common stock of Continental Airlines Inc. and accepted to limit its voting power and yet an antitrust lawsuit followed; the largest cable operator TCI passively invested and purchased 9 percent stake of the second-largest cable operator, Time Warner; and Gillette's acquired about 23 percent of the nonvoting stock and 13 percent of the debt of one of its main competitors, Wilkinson Sword.

7 European Commission, *White Paper: Towards More Effective EU Merger Control (2014)*, COM (2014) 449 final.

8 Global Competition Review, April 8, 2016.

9 https://ec.europa.eu/commission/commissioners/2014-2019/vestager/announcements/ refining-eu-merger-control-system_en.

10 Banal-Estanol, Seldeslachts & Vives, *The Financial Crisis' Impact on Common Ownership and Competition*, mimeo (2017).

improve performance. Large firms have more links due to overlapping ownership, better corporate governance, are more efficient, and command larger price/cost margins and earn higher profits. The result is that overlapping ownership and high price/cost margins and industry profits go together. Indeed, there is some evidence that passive investors use their voice and improve profitability (in terms of returns on assets)[11] and that cross-held firms have higher market share growth and profitability due to efficiency gains and enhanced innovation productivity.[12]

IV. WHAT IS IT THEN, MARKET POWER OR EFFICIENCY?

Banal-Estanol et al.[13] find that passive investors increased their holdings relative to active shareholders post-crisis (with data for 2004-2012 of all publicly listed firms in the U.S.). In principle, and other things equal, this should not lead to a higher degree of internalization of rivals' profits since passive investors exert less control than active ones. However, passive shareholders are (i) more diversified and (ii) have become more concentrated in the investment industry. This shift has led to more interconnected networks of common ownership and a potentially higher degree of internalization of rivals' profits. A (provisional) finding is that firms participated by passive investors increase both the degree of internalization and market share post crisis and that the effects are stronger in R&D intensive industries. In principle, both market power and efficiency interpretations of the results are possible. However, the authors show (tentatively) that this increase in passive and common ownership appears to have had a negative impact on product market competition (as measured by the profit elasticity of cost changes). This would be according to oligopoly theory (either of the Cournot or Bertrand variety) once common ownership patterns are taken into account.

Is there an efficiency defense? Overlapping ownership may help internalize R&D spillovers across firms and increase R&D effort when the spillovers are not too low. Empirical studies show, indeed, that R&D effort is suboptimal because of the presence of technological spillovers. The finding of López and Vives[14] is that if spillovers are high enough, then both R&D effort and output increase with a higher extent of overlapping ownership. In this context, a regulator would like to allow a certain degree of overlapping ownership, in particular when spillovers are high and R&D investment has a commitment value that influences competition in the marketplace. This is so since, in the latter case, firms have strong incentives to underinvest in R&D, say to expend effort to reduce production costs.

In summary, both theory and preliminary evidence point at potential antitrust concerns with the increase in common/overlapping ownership. This certainly calls for more antitrust scrutiny but, in my view, it is still early to advance and implement major changes in regulation and antitrust enforcement. Before that we need to have a better understanding of the channels of transmission of ownership patterns into competitive outcomes, via corporate governance,[15] and more empirical evidence of consumer harm and the effects on innovation.

11 Appel, Gormley & Keim, *Passive Investors, Not Passive Owners* (2016), available at: http://ssrn.com/abstract=2475150.

12 He & Huang, supra note 2.

13 Banal-Estanol, Seldeslachts & Vives, supra note 6.

14 López & Vives, *Overlapping Ownership, R&D Spillovers, and Antitrust Policy*, (2016), available at: http://blog.iese.edu/xvives/publications/unpublished-research/.

15 Anton, Ederer, Giné & Schmalz relate the rise of common ownership to decreases in relative performance evaluation. Anton, Ederer, Giné & Schmalz, *Common Ownership, Competition, and Top Management Incentives*, (2017), available at: https://ssrn.com/abstract=2885826.