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The new and controversial theories of harm stemming from common minority ownership of competing firms

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A recent set of papers have caused a stir in the antitrust community, highlighting what the authors contend is a little-noticed problem that may be undermining competition in concentrated industries. The focus of these papers is common ownership, defined here as an investor's simultaneous ownership of minority shareholdings in competing firms. In particular, the papers associate common ownership with higher prices for consumers, and management compensation structures that disincentivise aggressive competition. Several solutions have been proposed, based on the view that existing merger laws, or at least the approach of competition authorities to merger review, has not adequately prevented common ownership-related competition problems.

In December, the OECD hosted a hearing to explore this topic, and the potential solutions that have been proposed.[2] The discussion highlighted that this is still a developing area of antitrust knowledge, and that further analysis is warranted on the part of the academic community as well as competition authorities. The three questions set out below merit particular consideration.

How prevalent is common ownership?

Several contributions to the debate on common ownership highlight its extent in some economies and industries. For example, 60% of US public firms in 2014 had shareholders that also held at least 5% in a competing firm, up from less than 10% in 1980.[3] Particularly significant levels of common ownership have been observed in the US airline, retail banking, supermarket, soft drink and mobile phone industries. The largest firms in these industries often have at least some top shareholders in common.[4] European banks' largest shareholders also include horizontally-invested investment funds,[5] whereas pension funds appear to account for substantial levels of common ownership in the Icelandic real estate, insurance and telecommunications industries.[6]

There remains, however, quite a lot that we do not know about the prevalence of common ownership in the economy. First, much of the current research relies on data from US publicly-traded firms (who are required to report investors holding more than 5% of outstanding shares). Relatively little is known about common ownership among minority shareholders in private equity markets, which account for approximately US$4.7 trillion globally.[7] The nature of the investors, and potentially the competition harm, in unlisted firms may be different from listed companies. For example, the passive index funds that have acquired substantial shareholdings in publicly-listed competitors would not hold shares in unlisted companies, but other investment funds with industry-wide investment strategies might.

Secondly, there are signs that levels of common ownership may vary significantly across jurisdictions. For example, family businesses are significantly more common in South-East Asia and Latin America than in other regions, where firms may have different ownership structures (e.g. publicly-traded or government-owned

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[1] The opinions expressed and arguments employed herein are those of the authors and do not necessarily reflect the official views of the OECD or the OECD member countries.

[2] For further information, please visit: http://www.oecd.org/daf/competition/common-ownership-and-its-impact-on-competition.htm.

[3] He, J. and J. Huang (Forthcoming), "Product Market Competition in a World of Cross Ownership: Evidence from Institutional Blockholdings, Review of Financial Studies, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2380426.

[4] See, for instance, Schmalz, M. (2018), "Common-Ownership Concentration and Corporate Conduct", *Annual Review of Financial Economics,* Vol. 10, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3046829; Posner, E., F. Scott Morton & E.G. Weyl (Forthcoming), "A Proposal to Limit the Anti-Competitive Power of Institutional Investors", Antitrust Law Journal, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2872754.

[5] See, for instance, Azar, J. and M. Schmalz (2017), "Common Ownership of Competitors Raises Antitrust Concerns", Journal of European Competition Law & Practice, Vol. 8 (5), https://doi.org/10.1093/jeclap/lpx032.

[6] Óladóttir, A. D., Friðriksson F. A., Magnússon G., and Þráinsson V.(2017), "Serving the same masters while competing: Common ownership of listed companies in Iceland", Icelandic Review of Politics and Administration, Vol 13, No 1 http://www.irpa.is/article/view/a.2017.13.1.2/pdf.

[7] McKinsey Global Private Markets Review, February 2017, https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/a%20routinely%20exceptional%20year%20for%20private%20equity/mckinsey-global-private-markets-review-february-2017.ashx

firms).[8] Thus, horizontally-invested shareholders may be less common and less influential in certain jurisdictions where the presence of a single controlling shareholder may be more common.

Third, there are substantial variations in the degree of common ownership, and its competition implications, across industries, which makes a case-by-case assessment necessary. Industries with low concentration may be more difficult to influence via common ownership links, for example. The presence of large, undiversified investors in the industry could also be sufficient to offset any common ownership influences via the mechanisms described further below.

What competition harms may result from common ownership?

In essence, the theories of harm advanced in recent publications suggest that, even if the shareholdings involved are only minority positions, common ownership can affect firm conduct and dampen competition. The concern is that common ownership links may serve to facilitate collusion, or to incentivise firm management to make unilateral decisions that benefit shareholders with horizontal investments, thus softening competition. The latter theory about management incentives is the focus of the current debate, as it is somewhat more novel and complex than concerns about horizontal investors facilitating cartels. It rests on three insights about the behaviour of firms and investors in the presence of common ownership.

The first insight is that the portfolio value of a horizontally-invested shareholder could theoretically gain from the unilateral decision of a portfolio firm to raise prices, even if said decision is unprofitable from the individual firm's perspective. This is the case because the shareholder's other portfolio firms could capture the consumers diverted away from the price-increasing firm, offsetting the latter's losses while allowing the investor to benefit from its higher margins.

The second insight is that minority shareholders, such as horizontally-invested funds, could have substantial influence in the decisions of a firm. This influence can be strenghtened when institutional investors are among the largest single shareholders of a firm, and the remaining shareholding is dispersed among small investors who may be less likely to vote or participate actively in corporate governance. This situation is specifically considered in many merger control regimes, which would be triggered in the event that shareholder dispersion grants minority shareholdings decisive influence in the firm. Beyond voting, institutional investors have not been shy to exert influence by making clear their preferences about firm strategy, either in private meetings with management or in more public settings. The prominence of these investors is often sufficient to exert pressure on management to respond.

The third insight is that the influence of horizontally-invested firms can alter management incentives. One recent empirical study found that common ownership was associated with firm management compensation that emphasised industry performance, rather than a firm's performance relative to its peers.[9]

Another indirect way in which common ownership may affect management incentives is the absence of shareholder involvement that would otherwise be associated with large investment fund shareholdings. When an institutional investor takes a position in a single firm in an industry, it will generally wish to see the firm gain market share and achieve earnings growth. This can result in the investor playing an activist role, spurring management to take risks and compete aggressively. However, if a firm's largest shareholders are horizontally-invested, they may not assume an active role: a horizontal investor is certainly less likely to push for a price war or aggressive market share strategy if such a strategy would harm its other holdings in the market. Rather, management may be allowed to enjoy the "quiet life" of stable market shares and the avoidance of risk-taking

[8] See, for example, "Business in the Blood", *The Economist,* 1 November 2014, https://www.economist.com/news/business/21629385-companies-controlled-founding-families-remain-surprisingly-important-and-look-set-stay.

[9] Anton, M., F. Ederer, M. Giné and M. Schmalz (2016), "Common Ownership, Competition, and Top Management Incentives", European Corporate Governance Institute Finance Working Paper, No. 511, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2802332.

– particularly in markets with high entry barriers.

These theories, and the empirical studies that seek to substantiate them, are subject to a range of critiques which suggest that we still have a way to go to fully understand the effects of common ownership. While some anecdotal examples exist of horizontal investors influencing firm decisions in a way that could benefit competing firms,[10] the degree to which this is widespread is still unclear. For example, the large passive index funds that make up the top shareholders in some concentrated industries likely do not have enough employees to systematically advocate for firm decisions that benefit their horizontal holdings.[11] Indeed, a lack of institutional investor engagement in firm management has been a concern for corporate governance policy in recent years.

And even if institutional investors had the capacity to steer firm decisions away from competition that harms their portfolios, would it be easy for them to identify such opportunities? Having investments in upstream or downstream firms will make this an analytically challenging task: inflating prices in one market could harm portfolio performance in another.

Finally, decisions by management to benefit one group of shareholders over another would require the disadvantaged group to be fully passive. Otherwise, legal actions from the implied violation of fiduciary duty, or the emergence of proxy campaigns to reorient a firm towards individual profit maximization, could arise.

What measures should be taken to address potential competition harms from common ownership?

In response to the theories of harm we have described, some policy solutions have been proposed. These include some quite dramatic measures to prohibit portfolio diversification within an industry unless the investor commits to playing a fully passive role in corporate governance, as well as some efforts to reassure investors by developing safe harbours from existing competition laws. It should be noted that transactions giving rise to a substantial degree of influence, including minority acquisitions, may already be captured under merger control regimes in many jurisdictions – especially if the remaining shareholder structure is dispersed and thus a minority shareholding could grant decisive influence in a firm.

Before determining that legislative changes are neccessary, however, competition authorities may wish to start by better understanding the extent of common ownership in their markets. Obtaining insights from merger case handlers, cooperating with researchers, and even conducting market studies can help an authority identify industries in which common ownership may be substantial in their jurisdiction. Further analysis could be warranted in markets that feature high levels of common ownership and pre-existing competition concerns.

Beyond simply understanding where common ownership is present, the antitrust community must refine its understanding of how to empirically analyse common ownership. There remains substantial disagreement about the use of the modified Herfindahl-Hirschmann index to assess common ownership competition impacts, for example. Additional empirical approaches may be developed in the near future.

Finally, authorities can remain abreast of the academic debate regarding common ownership theories of harm, and consider whether such theories should be applied to transactions in concentrated industries, or in mergers of investment management funds. The OECD's hearing on common ownership feautured contributions from several jurisdictions that have already considered common ownership links in merger reviews.

[10] Schmalz, E. (2015), "How Passive Funds Prevent Competition", http://ericposner.com/martin-schmalz-how-passive-funds-prevent-competition/.

[11] See, for example, McCahery, J., Z. Sautner and L. Starks (Forthcoming), "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors", Journal of Finance, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571046.

Conclusion

To sum up, the debate about common ownership is one which merits further attention, if not immediate competition policy changes. Competition authorities need not simply be spectators in this process: they can engage actively with academia, and use their advocacy tools, including market studies, to help move the debate forward. They can also begin to consider common ownership links in merger cases when relevant - a process that has already begun.