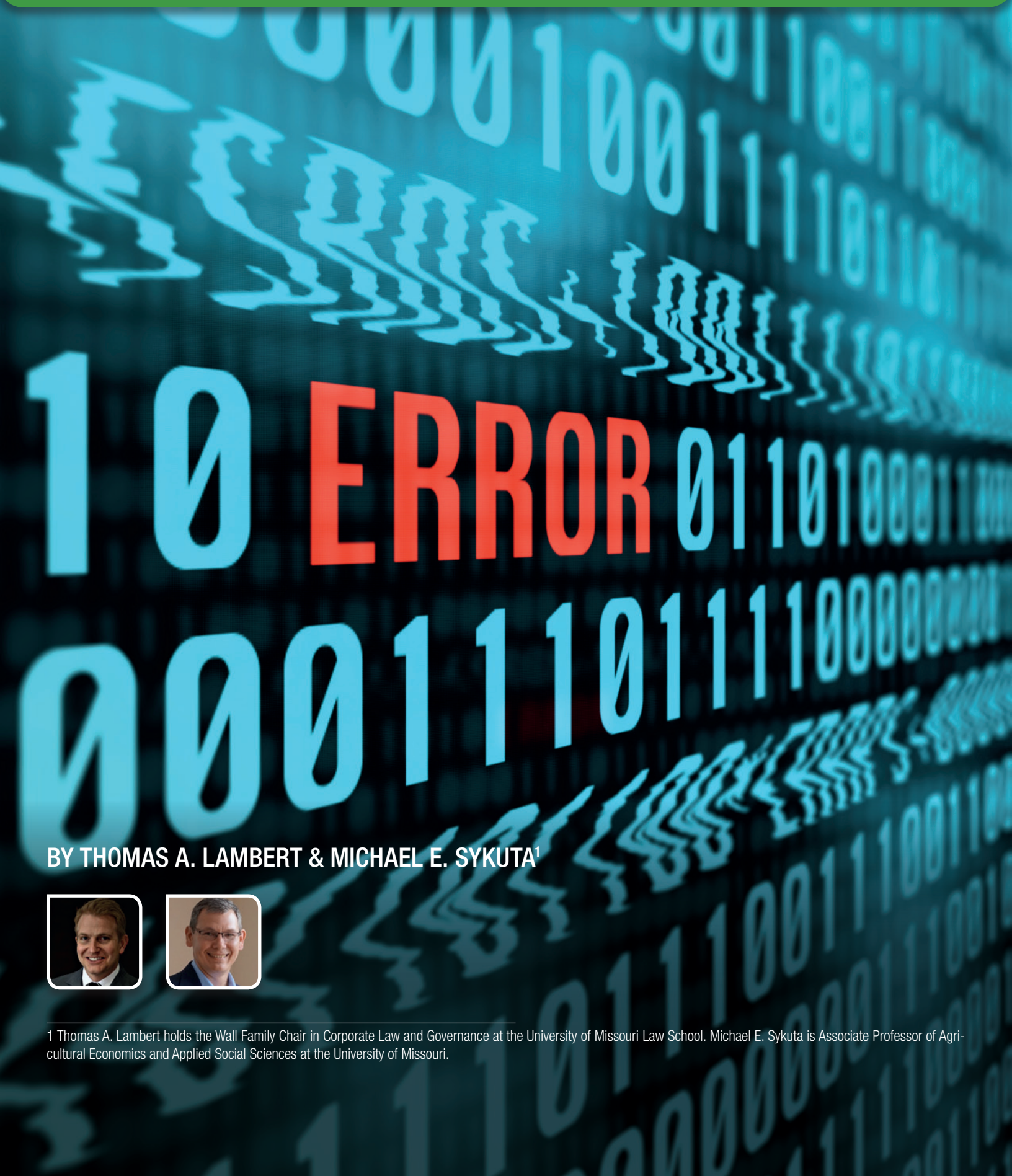
ARE THE REMEDIES FOR THE COMMON OWNERSHIP PROBLEM WORSE THAN THE DISEASE?: ASSESSING THE LIKELY DECISION AND ERROR COSTS OF PROPOSED ANTITRUST INTERVENTIONS



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CPI ANTITRUST CHRONICLE
MAY 2019

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I. INTRODUCTION

Prominent antitrust scholars have sounded alarms about large institutional investors' "common ownership" of small stakes in competing firms. Writing in the *Harvard Law Review*, Einer Elhauge proclaimed that "[a]n economic blockbuster has recently been exposed" — namely, "[a] small group of institutions has acquired large shareholdings in horizontal competitors throughout our economy, causing them to compete less vigorously against each other."[2] Eric Posner, Fiona Scott Morton, and Glen Weyl argued in the *Antitrust Law Journal* that "the concentration of markets through large institutional investors is the major new antitrust challenge of our time."[3]

These scholars contend that institutional investors' common ownership, or "intra-industry diversification," calls for additional antitrust intervention beyond enforcement of well-established rules designed to prevent collusive conduct (e.g. bans on hub-and-spoke conspiracies, anticompetitive information exchanges, conspiracy-facilitating devices, etc.). In Professor Elhauge's words, "Horizontal shareholding poses the greatest anticompetitive threat of our times, mainly because it is the one anticompetitive problem we are doing nothing about. This enforcement passivity is unwarranted."[4]

In this article, we question whether additional antitrust intervention, beyond enforcement of doctrines aimed at arresting collusion, is justified. We have elsewhere disputed the claim that institutional investors' intra-industry diversification creates a significant competitive problem.[5] We have shown that the theory of anticompetitive harm is flawed because it ignores both institutional investors' *inter*-industry diversification and the personal incentives of corporate managers to maximize own-firm, rather than industry, profits. We have also shown that the empirical studies purporting to support the theory — particularly the well-known airline study by Jose Azar, Martin Schmalz & Isabel Tecu[6] — are methodologically deficient because they (1) do not accurately assess institutional investors' incentives with respect to the behavior of their portfolio firms; and (2) suffer from endogeneity problems.

2 Einer Elhauge, *Horizontal Shareholding*, 129 Harv. L. Rev. 1267, 1267 (2016).

3 Eric A. Posner, Fiona Scott Morton, & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 Antitrust J. L. 669, 669-70 (2017).

4 Einer Elhauge, *How Horizontal Shareholding Harms Our Economy—And Why Antitrust Can Fix It*, page 104 (Dec. 4, 2018 Working Paper, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293822).

5 Thomas A. Lambert & Michael E. Sykuta, *The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms*, __ Va. L. & Bus. Rev. __ (forthcoming 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3173787.

6 Jose Azar, Martin Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. Fin. 1513 (Aug. 2018).

Here, we focus on the solutions scholars have suggested for addressing the purported problem of common ownership. We show that the proposed interventions would themselves create significant welfare losses. Accordingly, the "enforcement passivity" of which Professor Elhauge complains is, at least on the current record, appropriate.

II. THE PROPOSED INTERVENTIONS

Common ownership critics have proposed to police institutional investors' intra-industry diversification through public and private enforcement actions under Section 7 of the Clayton Act and Section 1 of the Sherman Act. While Section 7 is typically used to police anticompetitive mergers, its literal language, which forbids stock acquisitions that may substantially lessen competition, would appear to reach institutional investors' horizontal shareholding.[7] Section 1 of the Sherman Act prohibits "contracts" and "combinations" that unreasonably restrain trade.[8] Common ownership critics assert that holding small stakes in competing firms is a "combination" achieved via "contract" and that any resulting competition-softening would render the combination/contract unreasonable. Sections 7 and 1 are enforceable by the federal antitrust enforcement agencies as well as by states suing on behalf of their residents in *parens patriae* actions and by private plaintiffs.[9]

The touchstone for liability in these lawsuits would be a pattern of horizontal shareholding that could substantially lessen competition within some market. The most likely means of identifying such an ownership pattern would be through the use of the Modified Herfindahl-Hirschman Index (MHHI). MHHI adjusts the well-known Herfindahl-Hirschman Index (HHI)[10] to account for competition reductions occasioned by common ownership. It does so by adding "MHHIΔ" to HHI. MHHIΔ is a complicated metric that is designed to assess the degree to which the managers of firms within a market, assuming they seek to maximize their shareholders' returns, would cause their firms to eschew vigorous competition in favor of oligopolistic coordination in an effort to maximize industry (rather than own-firm) profits. MHHIΔ gauges the incentive for softened competition by accounting for (1) the size of the financial stakes intra-industry diversified investors hold in the firms competing in a market, and the degree to which, for each such investor, those stakes are equal across firms; (2) the degree of control intra-industry diversified investors exercise over those competing firms; (3) the degree to which the firms have non-diversified shareholders with control over firm management; and (4) the market shares of the competing firms that share common ownership by investors.[11]

Professor Elhauge has proposed MHHI-based thresholds for antitrust enforcement, suggesting that the federal antitrust agencies "should investigate any horizontal stock acquisitions that have created, or would create, [an MHHIΔ] of over 200 in a market with an MHHI over 2500, in order to determine whether those horizontal stock acquisitions raised prices or are likely to do so."[12] Liability would result where (1) common ownership has led to MHHI and MHHIΔ levels in excess of 2500 and 200, respectively; and (2) there are indications that common ownership has had, or threatens, an adverse price effect in the market. Professor Elhauge would also allow private treble damages actions when those requirements are met. For example, "[a] class of passengers injured by paying higher airline fares because of horizontal shareholdings on a concentrated route could . . . bring suit on the theory that the stock acquisitions by institutional investors that created those horizontal shareholdings harmed the passengers by lessening airline competition."[13]

Professors Posner, Weyl & Scott Morton agree with Elhauge that the anticompetitive potential from current levels of horizontal shareholding is sufficient to warrant additional antitrust intervention. They are not in favor, however, of relying on haphazard antitrust suits to address the problem. They instead propose a more rule-based approach, where the specifics of what is allowed and disallowed are set forth *ex ante*.

Under Posner et al.'s proposed rule, any investor holding more than 1 percent of the aggregate equity in an industry deemed oligopolistic by the Federal Trade Commission ("FTC") and U.S. Department of Justice ("DOJ") would be allowed to hold stock in only one firm within that

7 15 U.S.C. § 18 ("No person shall acquire … any part of the stock … of one or more persons engaged in commerce …, where in any line of commerce … the effect of such acquisition … may be substantially to lessen competition…").

8 15 U.S.C. §1.

9 15 U.S.C. §§ 15, 15a, 15c.

10 HHI is calculated by summing the squares of the market shares of the firms in a market. It ranges from near zero to 10,000 (at full monopoly: 100^2).

11 We have elsewhere provided a step-by-step guide to calculating MHHIΔ. See Lambert & Sykuta, supra note 5, at Appendix A.

12 Elhauge, *supra* note 2, at 1303.

13 *Id.*

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industry.[14] Investors holding less than 1 percent of total industry equity could own shares in multiple industry participants, as could free-standing index funds that committed to pure passivity within the industry.[15] To be "purely passive," the index fund would have to abstain from communicating with management, vote its shares in proportion to other shareholders' votes (negating any voting influence), and trade stocks only in accordance with pre-announced, non-discretionary rules (such as following a particular index as closely as possible).[16] Posner et al. suggest that the FTC and DOJ adopt this rule as an enforcement guideline.[17]

III. EVALUATING THE PROPOSED INTERVENTIONS

Antitrust policies inevitably entail social costs. If they prohibit or discourage efficient activities, the welfare from those activities is squandered. If they fail to prevent anticompetitive conduct, market output will be lower and welfare diminished. Taken together, the welfare losses from false convictions (Type 1 errors) and false acquittals (Type 2 errors) comprise a policy's "error costs."

Error costs may be reduced by making the policy more nuanced — e.g. by adding in exemptions, defenses, etc. in an effort to prevent the bad without discouraging the good. Adding complexity, however, increases the costs of determining what the law allows. Those are "decision costs."

These three sets of costs — false conviction error costs, false acquittal error costs, and decision costs — are intertwined. If policy makers attempt to reduce false acquittals by expanding the scope of a policy's prohibition, they risk false convictions; if they seek to avoid false convictions by making the policy more lenient, they increase the chance of false acquittals; if they add nuance in an effort to reduce both errors simultaneously, they enhance decision costs. Accordingly, antitrust policies should not pursue perfection along any single dimension — catch every anticompetitive act, allow every procompetitive one, minimize decision costs — but should instead seek to *optimize* by minimizing the sum of error and decision costs.

Judged according to this criterion, the additional antitrust interventions that have been proposed to address the common ownership problem do not pass muster. They would likely create greater losses than they would avert.

A. The Interventions' Decision Costs

Decision costs are the costs of determining whether conduct is legally permitted. Businesses must incur such costs in planning their affairs; adjudicators, in assessing whether an accused is liable and for how much. Because the additional antitrust interventions that have been proposed for policing common ownership involve highly complex inquiries, they would entail significant decision costs.

1. MHHI-based Lawsuits

Consider first the decision costs adjudicators would face in lawsuits under Sections 7 and 1. To assess whether the MHHI-based thresholds were met, adjudicators would have to define the markets in which firms with common shareholders compete and determine MHHI and MHHIΔ for each. Assuming the thresholds were exceeded, they would have to evaluate complicated econometric evidence to assess whether common ownership had raised or was likely to raise prices and to determine the magnitude of that price effect. The adjudicator would then have to answer a nearly intractable question: How should the economic harm from common ownership be allocated among the institutional investors holding stakes in multiple firms in the industry? It would not work to assign liability only to those diversified investors who could substantially reduce MHHIΔ by divesting, for oftentimes the unilateral divestment of each institutional investor from the market would occasion only a slight reduction in MHHIΔ.[18] An aggressive court might impose joint liability on all intra-industry diversified investors, but the investor(s) from whom the plaintiffs collected would likely seek contribution from the other intra-industry diversified investors. Denying contribution would be intolerably inequitable, but how would a court apportion damages?

14 Posner, et al., *supra* note 3, at 701.

15 *Id.* at 708-09.

16 *Id.*

17 *Id.* at 709.

18 See *id.* at 692-93 (offering example to illustrate that unilateral divestment may have little effect on MHHIΔ).

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The decision costs facing business planners seeking to avoid MHHI-based lawsuits would be even greater. Because no single institutional investor could prevent the adverse price effects that would satisfy the second element of Professor Elhauge's liability test, institutional investors could insulate themselves from liability only by negating the first, which would require them to abstain from common ownership in markets with MHHI and MHHIΔ above certain levels. That means planners would have to calculate MHHI and MHHIΔ in all markets in which their institutions held stock of multiple competitors. They would also have to engage in perpetual monitoring of those markets to see if MHHI and MHHIΔ had risen. Because a market's MHHI and MHHIΔ are influenced by (1) the market shares of participating firms, (2) the ownership percentages of intra-industry diversified investors, and (3) the ownership percentages of non-diversified shareholders, an institutional investor holding stakes in competing firms could find itself at risk of antitrust liability if the market shares of its portfolio firms rose, if other intra-industry diversified investors altered their holdings of firms within the industry, or if major non-diversified shareholders reduced their stakes. Planners for an institutional investor holding stakes in competing firms would have to recalculate MHHI and MHHIΔ on a near daily basis to ensure that the investor's stockholding — the one thing the investor can control — could not be deemed to have contributed to a softening of competition.

2. Posner et al.'s Enforcement Policy

On first glance, the enforcement policy proposed by Posner et al. might appear to lower decision costs. After all, business planners would have to do less investigation to avoid liability if they could rely on easily identifiable safe harbors, and adjudication costs would fall if the enforcement policy made it easier to spot illicit investment patterns. But Posner et al.'s proposed policy creates protection against only *public* enforcement actions. Because private plaintiffs might sue even if an institutional investor was within the public enforcement safe harbor, planners for institutional investors would still need to engage in the analysis described in the previous section. And, if such lawsuits were filed, courts would incur the adjudicative decision costs discussed above.

Moreover, the proposed enforcement policy would impose tremendous new decision costs on the public enforcement agencies. Under the policy, DOJ and FTC would be required to compile an annual list of oligopolistic industries. That would be a massive and costly undertaking, especially since (1) there is no agreed-upon, economically tractable definition of "industry" or "oligopoly" (i.e. something akin to the hypothetical monopolist/SSNIP test used to define antitrust markets); (2) the list would have to be constantly updated, as industry boundaries continually change and firms regularly enter and exit; and (3) designation of such a list would inspire all sorts of costly interest group manipulation. It is unlikely, then, that Posner et al.'s enforcement policy would reduce the decision costs of policing common ownership through additional antitrust interventions.

Of course, there is a scenario in which most of the decision costs described in this section could be avoided: If institutional investors were to respond to the threat of antitrust liability by ceasing to invest in multiple firms that compete in any concentrated markets, or by remaining fully passive at such firms,[19] then their business planners would not need to make costly assessments of antitrust risk, and adjudicators could avoid the difficult inquiries detailed above.[20] But this outcome, which appears to be the intended result of the proposals by Elhauge and Posner et al., would create substantial error costs.

B. The Interventions' Error Costs

Relative to the regulatory status quo, an antitrust intervention that drove institutional investors in concentrated industries either to forego intra-industry diversification or to remain fully passive may reduce Type II (false acquittal) error costs. If horizontal shareholding has *any* adverse competitive effect in *any* concentrated industry, and if that effect stems from the fact that intra-industry diversified investors are not wholly passive and therefore influence the competitive behavior of their portfolio firms, then an intervention that achieved the aforementioned result would reduce some anticompetitive harms.

Any reduction in Type II error costs, however, would likely be outweighed by an increase in Type I error costs. Indeed, each of the two possible results of stepped-up antitrust intervention — preclusion of intra-industry diversification in concentrated markets or inducement of full passivity by intra-industry diversified investors — would generate significant losses. The former would do so by eliminating welfare-enhancing product offerings; the latter, by exacerbating agency costs.

19 As noted, full passivity would require institutional investors to engage in mirror voting only, to avoid any communication with the management of portfolio companies, and to commit to an investment strategy with no investment discretion. See *supra* note 16 and accompanying text.

20 This outcome would not eliminate the decision costs resulting from the enforcement agencies' having to designate oligopolistic industries under the enforcement policy proposed by Posner et al.

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1. Precluding Intra-Industry Diversification

Driving institutional investors to refrain from intra-industry diversification would eliminate a multitude of investment products that create value for retail investors. Index funds would disappear, as nearly all significant stock indices include multiple competitors from concentrated industries. It is no answer to say that index funds could be offered as long as fund managers invested in only one of the indexed competitors from each concentrated industry, for any fund that was so managed would not be a true index fund, the defining characteristic of which is a lack of investment discretion (and consequently reduced management fees).

Inducing each institutional investor to select only one competitor per concentrated industry would also reduce the number of actively managed mutual funds available to retail investors. Because critics of common ownership maintain that intra-industry diversification *at the institutional investor level* is sufficient to induce competition-softening in concentrated markets, it would not be enough for institutional investors to ensure that each of their funds was invested in only one firm within an oligopolistic industry. Rather, each institutional investor would have to settle on one firm per concentrated industry for all its funds. This requirement would impede institutional investors' ability to offer a variety of actively managed funds organized around distinct investment strategies — e.g. growth, value, income etc. For example, if Southwest Airlines were a growth stock and United Airlines a value stock, an institutional investor could not offer both a growth fund including Southwest and a value fund including United.

Finally, institutional investors' eschewal of intra-industry diversification would prevent them from designing funds that bet on an industry as a whole while limiting exposure to company-specific risks within that industry. Suppose, for example, that a financial crisis led to a precipitous drop in the stock prices of all commercial banks. A retail investor might reasonably conclude that the market had overreacted with respect to the industry as a whole, that the industry would likely rebound, but that some commercial banks would probably fail. Such an investor would wish to invest in the commercial banking sector but to hold a diversified portfolio within that sector. A legal regime that drove fund families to avoid intra-industry diversification would prevent them from offering the sort of fund this investor would prefer.

2. Inducing Full Passivity

If institutional investors were to respond to potential antitrust liability not by avoiding intra-industry diversification but by remaining fully passive in any concentrated industries in which they held multiple stocks, the aforementioned error costs could be avoided. In that case, however, another set of significant error costs would emerge: increased "agency costs."

As Adolf Berle and Gardiner Means famously observed, large public corporations are characterized by a separation of ownership and control: The residual claimants of such corporations, the shareholders, have little control over the managers of the businesses, the directors and officers.[21] This separation of ownership and control may lead managers to direct firm resources not to their highest and best ends, as the owners would prefer (and efficiency demands), but to ends that create personal benefits for the managers. Those losses, together with the costs of efforts to avoid them, are agency costs.[22]

Since Andrei Shleifer & Robert Vishny's seminal 1986 paper on large shareholders and corporate control, scholars have repeatedly demonstrated the important role of large shareholders in reducing agency costs.[23] In their subsequent survey of alternate corporate governance systems, Shleifer & Vishny concluded that the optimal corporate governance regime is one with strong legal protections for small shareholders and active ownership by large investors.[24]

As large shareholders, institutional investors, if non-passive, may significantly reduce agency costs at their portfolio firms. Individual shareholders tend to be rationally ignorant of the information needed to engage in effective monitoring of manager-agents because such information is costly to obtain, and each individual shareholder's stake in the company is usually too small to justify the significant expenditures required to get up to speed. Large institutional investors, by contrast, have better access to relevant information (e.g. contacts with firm insiders), a superior ability to process it effectively (e.g. more business expertise, access to shareholder advisory services), and, given their larger stakes in

21 Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (Routledge, 2d ed. 1991) (first edition published 1932).

22 See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 308 (1976).

23 Andrei Shleifer & Robert Vishny, *Large Shareholders and Corporate Control*, 94 J Pol. Econ. 461 (1986).

24 Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J Fin. 737 (1996).

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the corporation, a greater motivation to become adequately informed. They therefore tend to be more effective, lower-cost monitors of managerial conduct.

Institutional investors with index funds are especially likely to reduce agency costs. If a company is included in an index that is tracked by a fund offered by an institutional investor, that investor cannot divest from the company and is thus a long-term investor. Empirical evidence suggests that institutional investors with long-term investment horizons significantly improve corporate management.

Consider, for example, a recent study by Jarrad Harford, Ambrus Kecskés & Sattar Mansi.[25] Examining a large panel of firm-years comprising around 3,000 firms annually over a near 30-year period, the authors assessed how stockholding by long-term institutional investors influenced corporate decision-making and performance. They found that investment by long-term institutional investors enhanced the qualifications of corporate managers, reduced measurable instances of managerial misbehavior, boosted innovation, decreased debt maturity (causing firms to become more exposed to financial market discipline), and increased shareholder returns. Their "overarching conclusion [was] that long-term investors are an important force of good corporate governance."[26]

Similarly, Audra Boone & Joshua White examined the effect of institutional ownership on firms' information and trading environments.[27] Again, using a panel of approximately 3000 firms annually over a period of 10 years, they found that firms with greater indexer ownership have richer public information settings, lower information asymmetry in the equity markets, and increased liquidity. They concluded that, "[b]y enhancing the information environment and potentially decreasing the monitoring and trading costs for all investors, indexers create value for other capital market participants."[28]

Inducing full passivity on the part of institutional investors would thwart significant welfare gains in the form of reductions in agency costs. Institutional investors could hardly be expected to invest in discovering information about managerial performance if they could not use that information to make voting decisions, to engage with managers, or to determine whether to sell, hold, or buy company stock. And it strains credulity to suppose that the laundry list of benefits discovered by Harford et al. could be achieved by long-term institutional investors that had no ability to influence managerial decision-making by either voice (engagement, voting) or threat of exit (selling shares held by their non-index funds).

IV. CONCLUSION

A market failure is a necessary, but insufficient, condition for a regulatory fix. Policymakers should always ask whether a proposed intervention would create greater welfare losses than it would avert. For reasons we have detailed elsewhere, we doubt that the anticompetitive effects of current levels of common ownership, if they exist at all, are significant. We have shown here that the welfare losses from proposed interventions to remedy common ownership harms are likely substantial. It seems, then, that the marginal costs of additional antitrust interventions to police common ownership (beyond enforcement of established rules on hub-and-spoke conspiracies, collusion-facilitative devices, etc.) may well exceed the marginal benefits those interventions would secure. If that is so, the current "enforcement passivity" Professor Elhauge complains of is appropriate.

25 Jarrad Harford, Ambrus Kecskés, & Sattar Mansi, *Do Long-Term Investors Improve Corporate Decision Making?*, 50 J. Corp. Fin. 424 (2018).

26 *Id.* at 452.

27 Audra Boone & Joshua White, *The Effect of Institutional Ownership on Firm Transparency and Information Production,* 117 J Fin. Econ. 508 (2015).

28 *Id.* at 510.

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