COMMON OWNERSHIP: DIVERGENCE AND CONVERGENCE BETWEEN RESEARCH AND THE PUBLIC POLICY DEBATE

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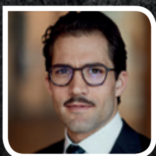

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I. INTRODUCTION

A decades-old literature in industrial organization predicts a unilateral reduction in incentives to compete when natural competitors share common investors (see Rotemberg 1984 for an early contribution showing that reduced cost of diversification, perhaps due to the emergence of mutual funds, can cause lessened competition;[2] see Schmalz (2018) for a comprehensive review of the literature).[3] In recent years, about two dozen papers have rejected the null hypothesis that common ownership doesn't matter for firms' competitive behavior or market outcomes (see Schmalz' testimony at the December 2018 FTC hearings).[4] Since then, researchers have debated preferred empirical methodologies (which differ across subfields of economics) and identified open theoretical issues for future research. Importantly, this debate has not produced any paper that that has empirically rejected the hypothesis that there are at least some anticompetitive effects of common ownership in specific subsets of markets, and instead offered strong support for the old paradigm that firms generally compete vigorously in their own self-interest, even if doing so goes against the interest of a (sometimes large) majority of the firm's shareholders.

II. GAPS BETWEEN PUBLIC DISCUSSION AND ACADEMIC KNOWLEDGE

In light of this history, it is curious to observe that some participants in the debate have maintained that the discussion was based on theories and hypotheses, as opposed to empirical facts (e.g. Novick WSJ 2017 claiming the hypotheses "lack factual support from the real world,"[5] or Hubbard (2019) "there is just no evidence").[6] A further claim involves that the debate is largely based on a single paper, namely Azar, Schmalz & Tecu (2018)'s "airline paper."[7] The fact is that by now, more than two dozen empirical studies have documented deviations from the traditional theory.

Yet, confusion continues to be spread also about the theoretical papers that started the literature. Contrary to the emphasis of much of the public debate, the primary concern from common ownership is not that asset managers facilitate information transfers or outright collusion between competitors (though, given the lack of data beyond anecdotes, there is no evidence rejecting that hypothesis). This confusion is difficult

2 Rotemberg J. (1984), "Financial transaction costs and industrial performance," Work. Pap., Sloan Sch. Manag., Mass. Inst. Technol., Cambridge.

3 Schmalz, M.C. (2018), "Common-Ownership Concentration and Corporate Conduct," Annual Review of Financial Economics, 10(1), pp. 413–448.

4 https://www.ftc.gov/news-events/audio-video/video/ftc-hearing-8-dec-6-remarks-ftc-commissioner-rohit-chopra.

5 Novick, Barbara (2017), Wall Street Journal, "How Index funds democratize investing."

6 Hubbard, Glenn (2019), https://www8.gsb.columbia.edu/valueinvesting/sites/valueinvesting/files/Graham%20%20Doddsville_Issue%2035_vPrint.pdf.

7 Azar J., Schmalz M.C. & Tecu I. (2018a), "Anticompetitive effects of common ownership," J. Finance. 73(4):1513–65.

to understand, given that already the earliest formal contributions to the literature made this point clear. For example, Rubinstein & Yaari (1983) wrote, "suppose collusion is impossible,"[8] and Rotemberg (1984) states ("In fact managers never need to meet each other.").[9] Instead, the primary concern is that if firms, to some extent, act in their most powerful shareholders' interest, and if these shareholders also hold interests in competitors, firms don't have strong incentives to maximize their own value but instead maximize a weighted average of their own and their competitors' values, corresponding to the composition of their shareholders' portfolios. As such, the evidence theory calls for is that common ownership leads to changes in firm behavior and competitive outcomes. Theory does not call for evidence that common ownership is linked to explicit or implicit collusive agreements (although some theories exist that make this prediction for specific cases of parameters and classes of models). I have addressed further confusions in the debate in OECD (2019).[10]

Factual errors also permeate the discussion. One is that a majority of shareholders in relevant industries don't, in fact, own competitor stock. Another is that common ownership has not been shown to robustly relate to competitive outcomes.

Regarding the first point, Rock & Rubinfeld (2017) base their argument of disbelief on existing empirical results on anticompetitive effects of common ownership on the claim that a large majority of shareholders doesn't in fact also hold competitors, and that managers would therefore have to act against the interest of the majority of shareholders if they were to act in common owners' interest.[11] However, this factual claim is not based on reality. Elhauge (2019) shows that a majority of the data published by Rock & Rubinfeld (2018) counterfactually *assumes* that a given shareholder doesn't hold competitors; these assumptions don't correspond to the empirical facts.[12] True common ownership levels, as reported in standard sources such as Thomson-Reuters' compilation of institutional shareholders' 13F filings or Capital IQ, are much higher than reported by Rock & Rubinfeld.

Regarding the second set of claims, Dennis et al. (2018) conclude that "Common ownership does not have anti-competitive effects in the airline industry."[13] This conclusion is based on the assertion that the results in Azar et al. (2018a) rely on weighting regressions by passenger volume, and are driven by the largest five percent of markets. Both of these claims are factually incorrect, as Azar et al. (2018b) verifiably show.[14] (All of Azar et al.'s data and code is available online.) The failure to find anticompetitive effects also in markets below the 95th percentile in terms of passenger volume on behalf of Dennis et al. (2018) appears to be due to their failure to aggregate 13F-reported holdings to the level governance is exercised.[15] This error, known to the authors since 2017, is still not fixed at the time of this writing. (Schmalz (2019) footnote 13 cites papers documenting *de-facto* centralized governance in the largest asset managers, in all but a small fraction of cases.)

More generally, however, there is no paper, to my knowledge, that has empirically rejected the hypothesis that there are any anticompetitive effects of common ownership in specific markets and industries. That includes Kennedy et al. (2017)'s structural study of a 10 percent subsample of U.S. airlines under common ownership. Whereas the paper doesn't find positive effects, it cannot reject that there are positive effects.[16]

That said, the quality of ownership data and the scarcity of price data limits the degree to which academic research can study the common ownership hypothesis. Industry has not been forthcoming with greater disclosure to enable such research, but instead urged regulators to focus attention on other topics (2018 ICI letter to the FTC).[17] The ball is therefore in regulators' court to offer improvements to data availability which would enable more and better research on the question.

8 Rubinstein A, Yaari M.E. (1983), "The competitive stock market as cartel maker: some examples," Work. Pap., Suntory Toyota Int. Cent. Econ. Relat. Discipl., Lond. Sch. Econ., London.

9 Rotemberg J. (1984), "Financial transaction costs and industrial performance," Work. Pap., Sloan Sch. Manag., Mass. Inst. Technol., Cambridge.

10 Schmalz M.C. (2017), "Common ownership and competition: facts, misconceptions, and what to do about it," Backgr. Pap., OECD Compet. Comm., 128th Meet., Paris.

11 Rock E.B. & Rubinfeld D.L. (2018), "Antitrust for institutional investors," Antitrust Law J. In press.

12 Elhauge E. (2018), "New evidence, proofs, and legal theories on horizontal shareholding," Work. Pap., Harvard Law Sch., Harvard Univ., Cambridge, MA.

13 Dennis P., Gerardi K. & Schenone C. (2017), "Common ownership does not have anti-competitive effects in the airline industry," Work. Pap., McIntire Sch. Commer., Univ. Va., Albemarle County.

14 Azar J., Schmalz M.C. & Tecu I. (2018b), "Reply to: "Common ownership does not have anticompetitive effects in the airline industry," Work. Pap., IESE Bus. Sch., Univ. Navarra, Barcelona, Spain.

15 *Ibid.*

16 See Azar J., Schmalz M.C. & Tecu I. (2017), "The competitive effects of common ownership: Economic foundations and empirical evidence: Reply," SSRN Work. Pap. 3044908.

17 https://www.ici.org/pdf/18_ici_common_ownership_ltr.pdf.

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A confusion also persists regarding the mechanism of influence of shareholders as it relates to this debate. Recent commentary legal literature emphasizes that, whereas there may be an empirical link between common ownership and lessened competition, research has not shown a causal mechanism between reduced incentives to compete and changes in competitive outcomes.[18] Many propose that future research should attempt to uncover any such link. I am doubtful whether this is a promising route to uncover relevant facts. As explained above, the theory is that firms whose most powerful shareholders also own large stakes in competitors have reduced incentives to compete, compared with firms that don't share common owners. Therefore, pointing to the absence of evidence of collusive agreements between firms connected to common ownership does not speak in any way to the question whether the theories have predictive power to explain competitive outcomes. Also, the proponents of this direction don't seem to apply the same standard of proof to the alternative theory, namely the one that firms will compete as vigorously in their own interest, as in the textbook models of competition, irrespective of their shareholders' economic interests, and irrespective of the degree of common ownership. To my knowledge, we have no direct "causal evidence" of the mechanism by which shareholders make firms behave against their interest.

Setting aside the confusion about collusion versus unilateral effects, the discussion also misses the more conceptual point that a causal interpretation of evidence always comes from the underlying theory – not from the evidence alone. As such, observing a theory is an impossible feat to scientists. Practitioners should thus be aware of differences in the use of language between economists and legal scholars.

III. POLICY DEBATE

The modal article discussing potential policy implications seems to focus on whether the workings of index funds or large investors should be changed in light of the theories and empirical findings discussed above. This reflex is natural to some, perhaps because, at the extremes of theory, cheaper diversification is indeed what causes reduced competition (Rotemberg 1984), and index funds reduce the cost of diversification for investors at least compared to direct purchases of diversified stock portfolios. However, index funds have not, in fact, been singled out as the most important harbinger of reduced competition resulting from common ownership, or even just of the secular increase in common ownership itself. Indeed, as governance is typically *de-facto* centralized across funds within fund families, research is not typically conducted at the fund-level at all; as such, index funds in particular are not often the object of study. Moreover, indexing is exonerated as the sole driver of the increase in common ownership by Backus et al. (2019).[19] Snapshots of ownership structures in particular industries indicate that Warren Buffett's Berkshire Hathaway – clearly not an index fund – is a much more important common owner of U.S. airlines than even the largest mutual fund families that offer index funds, such as BlackRock or Vanguard. As such, the response that policy should avoid addressing common ownership in order to protect index funds can at present perhaps be understood as a rhetorical device, but with the understanding that there is a limited link to existing research.

Another assertion in the policy debate concerns the claim that the existence of partial common ownership links across vertically related industries would somehow invalidate the idea that horizontal common ownership links are potentially problematic and deserve attention from researchers and policy makers. The argument appears to be that the economic interest of a common owner of all firms in the economy would be to maximize total welfare. Of course, that's not the case. Such an investor's economic interest would be to maximize total producer surplus. Shareholder welfare is not synonymous with economic efficiency. Therefore, concentrating power over corporations in the hands of a few has long been understood to be a threat to the proper working of a capitalistic system.

IV. CONVERGENCE AND THE PATH FORWARD

This short note was meant to illustrate that some of the most frequently-made arguments exchanged in the public debate are very far removed from the academic research. There is, at this stage, neither convincing theory nor empirical evidence that would justify a confident belief that common ownership at the levels currently observed in several markets doesn't affect competition compared to the benchmark in which each firm is perfectly separately owned. Perhaps this explains why the criticisms levied against recent empirical research have not effectively challenged the notion that horizontal common ownership is an important antitrust problem.

18 See Rock E.B. & Rubinfeld D.L. (2018), "Antitrust for institutional investors," Antitrust Law J. In press and others.

19 Backus M., Conlon C. & Sinkinson M. (2018), "Competition and common ownership in the ready-to-eat cereal industry," Work. Pap., Grad. Sch. Bus., Columbia Univ., New York.

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A more useful way of continuing the debate would be to lay to rest arguments known to be flawed and instead to promote future academic research on the many open questions that remain to be addressed. For example, what are the welfare effects of any returns to scale in asset management, including any positive effect of concentration in asset management on the quality of firm governance? Given that asset managers aren't the ultimate owners of the shares, to what extent should we care about whether restrictions on their portfolios lead to a loss of diversification benefits in the portfolio? Are ultimate owners diversified across asset managers? If not, how costly would it be for individuals to diversify across asset managers? How does any such increased cost of achieving diversification on behalf of individual households compare to the likely welfare loss due to anticompetitive effects of common ownership? How does the answer vary across individuals along the wealth distribution? Quantitative answers to these questions would be useful in debating optimal policy responses to the rise of common ownership.

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