

**ICGN**

International Corporate Governance Network

ICGN Viewpoint

Common ownership: do institutional investors really promote anti-competitive behaviour?

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Common ownership, sometimes referred to as horizontal shareholding, is a term that reflects the investment practice of many institutional investors (which we define here to be both asset owners and asset managers) to hold investment positions in more than one company competing in the same sector. Its developing ubiquity stems from the growing share of institutional ownership in stock markets around the world. In particular, it reflects the prevalence of institutional investors with investment strategies, both active and passive, that involve significant portfolio diversification.

A debate is building in the academic community as to the economic impact of common ownership, particularly with regard to its potential to motivate anti-competitive practices by companies in the same sector owned by its “common” investors. To many institutional investors and financial practitioners, this anti-competitive argument may seem initially as an arcane scholarly debate. But, in extremis, the regulatory policy implications of this academic challenge to common ownership are potentially severe and disproportionate. Taken seriously, this challenge could marginalise investors and undermine their fundamental ownership rights, at a time when regulators globally are pressing for more investors to exercise their stewardship obligations.

ICGN believes that this challenge to common ownership is ill-founded, and lacking in both an understanding of institutional investment practice and clear evidence. Accordingly, we believe that any blunt legislative initiatives to quell the perceived problem of common ownership would be retrograde, reducing the rights of investors and resulting in unintended consequences anathema to good corporate governance and good stewardship.

How is common ownership a potential problem?

The reality of common ownership is not in dispute, but its impacts are. Modern Portfolio Theory, which has a strong influence on investment strategies of institutional investors, often leads to investors holding a diverse portfolio of corporate equities, which can include positions in several companies in the same sector. This is particularly the case for passive investment strategies, where investors seek to reduce company-specific unsystematic risk by investing in the market as a whole, often defined through benchmark market indices. In such cases, the selection of individual corporate equities as investment holdings is driven by the index itself, rather than by active portfolio construction by institutional investors.

While this approach to common ownership is generally regarded as orthodox through the lens of portfolio theory and is well-established in current investment practices, its challenges come through a confluence of microeconomic and legal arguments. The

microeconomic argument suggests that firms in a sector owned by overlapping sets of investors have reduced incentives to compete. The logic to this is clear enough. When investors have more than one corporate holding within the same sector, it stands to reason that they hope all of these corporates are successful, not just one (even though some will inevitably perform better than others). This microeconomic theory suggests that investors, will encourage, explicitly or implicitly, anti-competitive practices that benefit the companies involved – and their investors – at the expense of consumers and the public good more generally. Empirical research, focusing specifically on the airline sector, has suggested that the impact of common ownership was to inflate the cost airline tickets for consumers by 3-7% relative to normal competitive pricing.¹

This microeconomic challenge opens the legal debate to antitrust scholars, where some suggest that common ownership not only distorts pure competition between firms, but also leads to other negative externalities, such as a lower level of corporate investment, the high level of executive pay and, more generally, to a higher level of income inequality.² From a legal perspective, scholars suggest that common ownership might run afoul of anticorruption legislation, such as the Sherman Antitrust Act of 1890 in the US and its extension through The Clayton Act of 1914. This legal scrutiny is not limited to the US, however, and has also extended to EU Competition Law.³

Implications of the debate: common ownership versus stewardship

To the extent common ownership is suspected to be associated with illegal or anti-competitive practices, public policy responses inevitably will seek to identify ways in which to minimise or neutralise its impact. This has led to scholarly suggestions for regulatory action that would have the effect of throttling fundamental shareholder rights. Potential remedies include limiting the percentage of equity owned by an individual investor with multiple holdings in the same sector, a requirement to only hold one company in a given sector or to restrict an investor's rights to vote at AGMs or engage with companies.

Even though speculative at this stage, academic proposals of this nature are regarded by most investors as grossly ill-conceived, and also possibly unwittingly detrimental to the goals of investor stewardship. This is a time when stewardship codes are taking root in markets globally; momentum is building around the world for positive investor engagement with companies to promote long-term company success. Yet those who oppose common ownership somehow seem to presuppose

¹ See: Azar, José and Schmalz, Martin C. and Tecu, Isabel, Anticompetitive Effects of Common Ownership (May 10, 2018). *Journal of Finance*, 73(4), 2018. Available at SSRN: <https://ssrn.com/abstract=2427345>, or <http://dx.doi.org/10.2139/ssrn.2427345>

² See: Elhauge, Einer, The Growing Problem of Horizontal Shareholding (June 15, 2017). *Antitrust Chronicle*, Vol. 3, June 2017, Competition Policy International; Harvard Public Law Working Paper No. 17-36. Available at SSRN: <https://ssrn.com/abstract=2988281>

³ See: Elhauge, Einer, Tackling Horizontal Shareholding: an Update and Extension to the Sherman Act and EU Competition Law, Organisation for Economic Cooperation and Development, 28 November 2017.

that investor engagement amounts to some form of behind-the-scenes conniving between investors and competing companies in a given sector, plotting to game the industry at the expense of customers and broader society. Informed observers of institutional practice recognise the absurdity of such a proposition.

The extreme remedies put on the table to address potential problems of common ownership call for a clear investor riposte. A challenge to the rights of institutional investors with common ownership positions could deny a shareholder's right to vote at general meetings or engage with both executive management and the board. These are among the core principles of most stewardship codes found around the world, and to challenge these is to undermine the potential of investor stewardship and the voice of minority shareholders. From this, prescriptive legislative initiatives to address potential anti-competitive aspects of common ownership would prompt nasty side effects that are likely to be much greater in negative impact than any problem they may be seeking to resolve.

Institutional practice

Before jumping to remedies to mitigate the potential ills of common ownership it is important to explore the practicality of this anti-competitive claim within the context of institutional investment practice. Specifically, though critiques of common ownership might be able to explain a possible economic motive for market distortion, they have yet to credibly identify a practical mechanism through which investors might actually distort industry competition.

Institutional investors - both asset managers and asset owners- typically manage a variety of funds, with different fund managers and investment styles within individual institutions. A significant proportion of institutional assets under management relates to pension funds and other forms of long-term savings for individuals. These long-term savers and pensioners are the ultimate beneficiaries at the end of the asset chain. In many cases investment management agreements with their institutional investors will provide these end investors with exposure to hundreds, if not thousands, of corporate holdings through both active and passive investment strategies. This high degree of portfolio diversification largely reflects modern financial theory to diversify corporate holdings to reduce unsystematic portfolio risk as a matter of fiduciary prudence. Seen in this context, investment practices that result in common ownership is not motivated intrinsically by a desire to exploit, or even to encourage, anti-competitive practices.

Even if there were to be such a motivation, the impracticalities of any institutional investor's ability to systematically distort competition are staggering. First, there is the question of economic influence. Even the largest of the index funds will have very small absolute ownership stakes in individual companies, typically less than 5%, and more often far less. While stakes of this size can have influence in some questions relating to proxy voting or other governance matters it is difficult to imagine how a single institutional investor with small absolute holdings would have the motive, let alone the influence or resources, to promote uncompetitive practices across an entire industrial sector. Moreover, within the context of the Global Industry Classification Standards (GICS) there are 11 sectors, 24 industry groups, 68 industries and 157

sub-industries. Do opponents of common ownership suppose that institutional investors have the inclination and capacity to articulate and advocate anti-competitive strategies across this spectrum?

What does the evidence say?

The papers of Elhauge and Azar et al., cited earlier, produced empirical evidence focusing on the airline sector suggesting that common ownership by institutional investors results in distorted competition along several factors, including ticket prices. Azar et al.'s empirical paper has been published in 2018 in the highly regarded *Journal of Finance*. Elhauge also issued a further paper on horizontal shareholding in 2018, defending his arguments from his critics, and presenting “economic proofs” which show that “without any need for coordination or communication, horizontal shareholding will cause corporate managers to lessen competition to the extent they care about their vote share or re-election odds and will cause executive compensation to be based less on firm performance and more on industry performance.”⁴ These findings gave energy to the controversy around common ownership, as well as a foundation for possible regulatory responses to limit shareholder rights.

Yet this debate has also prompted a response from other academics and practitioners refuting these claims, both with regard to common ownership generally, as well as re-examining the specific evidence relating to anti-competitive effects in the airline sector. Of note, for example, is a 2018 paper titled “Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry,” which refutes the conclusions from the paper by Azar et al.⁵ A new wave of research is developing, including papers by other academics, practitioners and regulators examining common ownership who also cast doubt on the conclusions and prescriptions of the Elhauge and Azar et al. papers for reasons that are methodological, empirical or based on practical institutional knowledge.

While this debate continues to be waged in academic circles, the evidence that common ownership causes anti-competitive problems is mixed at best.⁶ Given the severe loss of shareholder rights that could result from any policy prescriptions, those who believe that common ownership by institutional investors poses a threat to competition have a substantial burden of proof that remains to be met if the harsh remedies they propose are ever to be taken credibly within the investment community.

Might there be some circumstances where the potential abuses from common ownership could be more prevalent? To give the theorists their due, this is an issue

⁴ See Elhauge, Einer, New Evidence, Proofs, and Legal Theories on Horizontal Shareholding (January 4, 2018). Available at SSRN: <https://ssrn.com/abstract=3096812> or <http://dx.doi.org/10.2139/ssrn.3096812>

⁵ See Dennis, Patrick J. and Gerardi, Kristopher and Schenone, Carola: “Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry” (February 5, 2018), available at SSRN: <https://ssrn.com/abstract=3063465>

⁶ A good summary of the leading academic research on this topic can be found on a dedicated webpage of the European Corporate Governance Institute: <https://ecgi.global/content/common-ownership>

that should be monitored. While it is unlikely, if not far-fetched, that the concerns relating to common ownership are justified by the current practices of large institutional investors, there may be other investor types and investment styles that could warrant greater scrutiny. This might be the case for direct investors, such as activist hedge funds, with smaller, more concentrated positions in companies and potentially a greater ability to influence company or sectoral practices. It would still be a tall order to demonstrate that common ownership is an anti-competitive problem in these cases. But for more focused portfolios there would be fewer practical obstacles to anti-competitive influences than in the case of large institutional investors with widely diversified holdings.

Conclusion

What might work in theory does not necessarily play out in practice; there can be obstacles. Common ownership is an example of this, especially when taking into account the practices – and the limitations – of institutional investors with regard to their exercise of shareholder rights. Institutional investors are increasingly focusing on sustainable value creation over a long-term horizon to provide stable returns for their beneficiaries. Distorting industry competition to achieve these goals is not part of this formula, and would run counter to the growing focus on broader social and environmental factors as investment and stewardship considerations.

Particularly for institutional investors with long-term investment horizons on behalf of pensioners and long-term savers as ultimate beneficiaries, a building awareness of systemic risk recognises that healthy companies benefit from healthy markets and societies. From this it follows that investors of this nature do not have a rational incentive to cheat or to distort competition against consumers or broader social interests. Moreover, institutional practicalities and investment practices suggest the sheer magnitude of the challenge do so, even if there were some incentive.

Remedies currently on the table to offset the potential ills of common ownership would challenge fundamental shareholder rights that are fundamental to good stewardship. Investors generally regard such proposals as solutions to a problem that does not exist, with potentially negative and far reaching implications that amount to stifling the minority shareholder voice. ICGN will continue to monitor and contribute to this debate, particularly when the basic rights and protections of investors are put under threat.

About ICGN Viewpoints

This ICGN Viewpoint was drafted by ICGN Policy Director George Dallas. While not defining a formal ICGN position on the subject, ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate. ICGN Viewpoints are produced by Secretariat and by our member-led Policy Committees, and we encourage dialogue by the ICGN Secretariat as follows:

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