Proposed Changes to the Merger Guidelines' Approach to Common Ownership

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I appreciate the opportunity to submit a comment in response to the FTC's Request for Information on Merger Enforcement.[1] This comment focuses on responding to Question 12.h of the Request, which asks whether changes should be made to the guidelines' approach to common ownership and horizontal stockholding. I argue that recent evidence confirms the link between common ownership and anticompetitive effects and identifies a relevant causal mechanism. I then offer a new framework based in economics for evaluating policy proposals intended to address anticompetitive effects of common ownership. I conclude by calling for regulators to make data on corporate ownership more available so that the problem of common ownership can be further studied, and by calling for the FTC to incorporate "modified" HHIs into the guidelines to account for the effects of common and cross-ownership.

A. Advances in Our Understanding of the Anticompetitive Effects of Common Ownership

Leaders in American antitrust enforcement and competition policy have expressed skepticism of proposed changes to common ownership policy on the grounds that there is not a clear causal mechanism linking common ownership to anticompetitive outcomes.[2] But a recent paper I coauthored offers a theoretical model and empirical evidence identifying a mechanism of harm.[3]

Our model modifies the standard model of optimal executive compensation amid a moral hazard problem so that firms strategically interact, and shareholders are permitted to hold more than one firm. The key mechanism of harm is that common ownership leads to less performance-sensitive managerial incentives, leading to higher costs and higher product prices. This is because more performance-sensitive managerial incentives induce top managers to exert greater effort in reducing the firm's costs. But when firms strategically interact, firms with lower cost will produce more output and set lower prices, imposing a negative externality on competitors. Shareholders holding competing firms then internalize this externality. To avoid this externality, common owners underinvest in corporate governance and institute less performance-sensitive

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[1] This comment is largely adapted from Martin C. Schmalz, *Conceptual Breakthroughs on Common Ownership and Competition: A Framework for Evaluating Policy* (forthcoming), https://ssrn.com/abstract=4032943.

[2] *See* Noah Joshua Phillips, Commissioner, Fed. Trade Comm'n, Opening Remarks at FTC Hearing #8: Competition and Consumer Protection in the 21st Century Corporate Governance, Institutional Investors, and Common Ownership (Dec. 6, 2018); Robert Jackson Jr., Commissioner, Sec. & Exch. Comm'n, Testimony Before the Federal Trade Commission Hearing on Competition and Consumer Protection (Dec. 6, 2018).

[3] Miguel Antón et al., *Common Ownership, Competition, and Top Management Incentives*, (Eur. Corp. Governance Inst., Finance Working Paper No. 511/2017, 2022), http://ssrn.com/abstract_id=2802332.

managerial incentives. Our paper further provides empirical evidence of a negative relationship between common ownership and performance-sensitive managerial incentives.

Skeptics of common ownership policy reform have also expressed doubts regarding the possibility that top management economic incentives actually affect market-level pricing decisions given the organizational complexity of modern firms.[4] The question is whether market-level actors that make pricing decisions would actually respond to these incentives. Our model accounts for this organizational complexity: the market-level pricing specialist in our model lacks knowledge about either common ownership or the top manager's incentives but takes the firm's cost as given. The model also explicitly models the endogeneity of market shares, and shows that it is not to the contrary of the existence of anticompetitive effects of common ownership.

A second paper by Azar and Ribeiro offers a structural estimation of a model featuring agency conflicts, which also finds that managers take shareholders' portfolio interest into account, albeit at a level significantly below what one would expect absent agency conflicts.[5] The take-away from both our model and the Azar and Ribeiro model is that the recognition of agency problems does not put in doubt the existence of anticompetitive effects of common ownership.

Some have also expressed concern that models of common ownership have failed to consider the effect of vertical common ownership. The argument is that common owners would not want to allow upstream firms to pass higher costs onto downstream commonly owned firms that are owned by the same index funds.[6] Formal economic theories have little tractability in answering this question, but a recent paper by Azar and Vives found that controlling for the extent to which airlines have vertical common ownership links has a negative effect on prices but increases the positive estimate of the price effects of horizontal common ownership links.[7] In other words, in the airlines industry, which has been the poster child of common ownership research, recognizing the role of vertical common ownership links actually strengthens the finding that common ownership of horizontal competitors increases price. Regulators can enforce anticompetitive effects of common ownership while at the same time strengthening pro-competitive effects of vertical relationships, as my discussion of policy proposals that follows demonstrates.

B. A Framework for Evaluating Common Ownership Policy Proposals

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[4] Jackson, *supra* note 2.
[5] José Azar & Ricardo Ribeiro, *Estimating Oligopoly with Shareholder Voting Models* (IESE Bus. Sch., Working Paper, 2022), https://ssrn.com/abstract=3988265.
[6] Barbara Novick, *How Index Funds Democratize Investing,* WALL ST. J., Jan. 9, 2017, https://www.wsj.com/articles/how-index-funds-democratize-investing-1483914571.
[7] José Azar & Xavier Vives, *Revisiting the Anticompetitive Effects of Common Ownership* (IESE Bus. Sch., Working Paper, 2021),

We now have solid evidence establishing anticompetitive effects of horizontal common ownership with various alternative methods and from alternative industries. Legal scholars and policymakers have begun constructing potential policy solutions to address these effects. In a recent paper, I created a simple economic framework for organizing and analyzing these proposals.[8]

The framework consists of three objectives. First, we must recognize that the anticompetitive effects of common ownership are created when within-industry diversification is achieved at the same level at which corporate control is exercised. Any solutions to this problem must separate these levels, either by effectively limiting the influence of asset managers with portfolios that are diversified across competitors, or by effectively limiting asset managers to diversifying across industries and leaving diversification within industries to the ultimate asset owners. The second insight is that it is impossible to independently address the antitrust and governance aspects of the common ownership problem. It is not enough to simply address governance mechanisms that may cause common ownership to increase profit margins; proposals must also address the lack of incentives for good governance practices, because the lack of good governance can lead to a lessening of productive efficiency and thus higher prices. Third, policymakers should minimize disruptions to asset markets subject to attaining the first two goals.

This framework can help lawmakers to evaluate the relative economic merits of the various policy proposals currently on the table. For example, one proposal would prevent the anticompetitive effects of common ownership through enforcement via Section 7 of the Clayton Act.[9] A second proposal would exempt institutional investors that hold less than a 1% share of more than a single effective firm in an oligopoly from antitrust scrutiny. Such holdings would also be considered harmless when the entity is an index fund that is passive with respect to portfolio choice and governance activities.[10] And a third proposal would create a safe haven for institutional investors holding less than 15% of the issuer's stock, do not have board representation, and only engage in "normal" governance activities.[11]

The first proposal might have difficulty satisfying the first prong of the framework if the relevant judges could not be persuaded to adopt a suitable interpretation of Section 7. However, this proposal satisfies the second prong of the framework by attacking the anticompetitive incentives created by the holdings rather than specific governance channels. And it could avoid excessive disruption of asset markets by merely enforcing an already existing law – although the extent to which it avoids disruption could be a product of its failure to strengthen competition, thereby defeating the primary objective of the framework.

The second proposal appears to satisfy all three prongs of the framework. By limiting the conditions under which a single entity can hold competitors, it separates the levels at which

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[8] Schmalz, *supra* note 1.
[9] Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1301-16 (2016).
[10] Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669 (2017).
[11] Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L. J. 221 (2018).

within-industry diversification is achieved and corporate control is exercised. Further, this goal can be achieved without a loss of diversification to households.[12] The second proposal also strengthens corporate governance both by increasing the stake investors hold in firms and by removing disincentives to engage in governance. And whether the second proposal would be more disruptive to asset markets than other proposals is unclear.

On the other hand, the third proposal does not meet either of the first two objectives of the framework. This is because the proposal rests on the erroneous assumption that active involvement in corporate governance is necessary for common ownership to lessen competition. But the first part of this comment establishes that no such involvement is necessary for common ownership to create anticompetitive effects. Rather, passive investors and executive compensation are sufficient to cause these effects.

The paper also points out that the new practice of passing on control rights to asset owners does not separate diversification and control, and therefore is unlikely to limit anticompetitive effects of common ownership.

In sum, a proper economic framework is necessary to organize and compare the policy proposals on common ownership. Furthermore, while economic research has advanced sufficiently to show that common ownership has anticompetitive effects in specific markets, it is still unable to precisely predict the effects of these proposals in terms of the changes to equilibrium in asset markets. The limits of economic research should not be used as a "killer" argument to forestall regulation while implicitly accepting further harm to the economy by letting common ownership continue to grow unchecked and indeed unmeasured.

C. The Need for High-Quality Data on Corporate Ownership

A lack of high-quality data on corporate ownership has been one of the main impediments to further advances in our understanding of the common ownership problem. In particular, disclosures under Schedules 13D (for activist investors) and 13G (for individual block holders or large insiders) are not easily obtained compared to 13F filings by passive institutional investors.[13] The absence of this data has led some studies to underestimate the anticompetitive effects of common ownership.[14] A recent study that combined information from 13F filings with information on 13D and 13G block holders found that the effects of common ownership on incentives were almost two times larger than when only 13F institutions were considered.[15]

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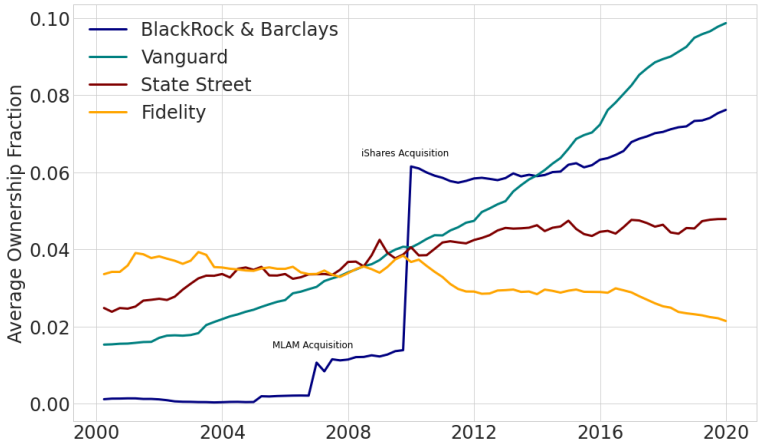
[12] *See*, Schmalz, *supra* note 1, at 26.
[13] Schmalz, *supra* note 1, at 15.
[14] *See* José Azar, Martin C. Schmalz & Isabel Tecu, *Research on the Competitive Consequences of Common Ownership: A Methodological Critique*, 66 ANTITRUST BULLITEN 113 (2021).
[15] Anton et al., *supra* note 3.

A second study further displays the need for high-quality data on common ownership.[16] Prior research had concluded that the "Big 3" asset management firms (Blackrock, Vanguard, and State Street) do not drive common ownership. But our research, which uses a more a comprehensive set of ownership records, comes to the opposite conclusion.[17] It is clear that more complete data is necessary for scholars to understand the scope and nature of the common ownership problem. Regulators could easily rectify this problem, and the cost to society of withholding this data far outweighs the minimal costs and public good character of supplying it.

Figure 1 below illustrates changes in corporate control that arise from consolidation of asset managers, constructed from the same data.

Figure 1. Average Ownership Stakes by Big 4 Asset Management Firms[18]



D. The FTC Should Consider Using Modified HHIs for Screens

A simple start for the FTC to incorporate insights from the common ownership literature into the guidelines would be to use "modified" HHIs (MHHIs) in addition to HHIs in developing new merger thresholds. MHHIs were developed to extend the HHI to incorporate partial ownership situations.[19] In a recent paper, my coauthors and I developed a generalization of the HHI ("GHHI"), which accounts for both common ownership and cross-ownership.[20] Applying the

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[16] Amir Amel-Zadeh, Fiona Kasperk & Martin Schmalz, *Measuring Common Ownership: The Role of Blockholders and Insiders* (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4059513.
[17] *Id.* at 32 tbl.4.
[18] Amel-Zadeh, Kasperk & Schmalz, *supra* note 16, at 38 fig.A.8. This figure depicts the average stake size in S&P500 firms held by the four largest investment management companies: BlackRock, Fidelity, State Street and Vanguard. The acquisitions of Meryll Lynch Investment Management and Barclays Global Investors are the reason for the jumps in BlackRock's average ownership stake.
[19] *See* Steven C. Salop & Daniel P. O'Brien, *Competitive Effects of Partial Ownership: Financial Interest and Corporate Control*, 67 ANTITRUST L. J. 559 (2000).
[20] José Azar, Sahil Raina & Martin Schmalz, *Ultimate Ownership and Bank Competition*, 51 FIN. MGMT. 227 (2022)

GHHI to national-level bank concentration reveals significantly higher levels of concentration than the basic HHI. MHHIs are also better at predicting consumer prices in several key industries, including airlines and banking.[21] Furthermore, MHHI deltas (the differences between MHHIs and HHIs) are negatively correlated with HHIs.[22] Thus omitting MHHIs can lead to omitted variable bias as a merely econometric matter. That said, challenges of interpretation arise when applying these measures in the context of mergers. For example, MHHIs have certain weaknesses, including potentially endogenous market shares, but these weaknesses are also a feature of the HHI metric that is already in use. An alternative is to use "profit weights" that are a component of MHHIs and used elsewhere in the literature, including by Amel-Zadeh, Kasperk, and Schmalz detailed above. To reflect the nuances of the understanding of their features, MHHIs should be used thoughtfully and in conjunction with HHIs.

E. Conclusion

Recent advances in economic research on the common ownership problem have brought us beyond the point of uncertainty regarding its anticompetitive effects. It is therefore time for the FTC to include at least the measurement of common ownership in its practices. The time has come for policymakers to confront the problem directly, and the merger guidelines offer a powerful starting point for these reforms. A framework based on separating common ownership from corporate governance, addressing the lack of incentives for good governance practices, and minimizing disruptions to asset markets can help guide policymakers in evaluating the proposals that have been set forth. Regulators can further bolster efforts to address the common ownership problem by providing curated data on corporate ownership, and by incorporating MHHIs into the guidelines. Together, these tools offer a path forward for protecting consumers from the anticompetitive effects of common ownership.

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[21] *Id*.