The Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
Canberra ACT 2600

From:
Martin Schmalz and Thomas Reyntjens
University of Oxford

16 September 2021

To the Members of the Standing Committee on Economics,

Your inquiry into the implications of common ownership and capital concentration in Australia

We write to you from the University of Oxford, where we do research on the subject-matter of your inquiry. We welcome the opportunity to contribute and hope that our comments are useful to your fact finding and policy making.

The first six sections of our contribution address each of your terms of reference in turn. We then make some additional comments in subsequent sections. Our key points are as follows:

- The default model is not that firms will compete. Only if firms have the right incentives they will compete, and such incentives can come from shareholder pressure. Common owners, however, have reduced incentives to push the firms they have invested in to compete, or they at least take the place of potential undiversified shareholders with a larger stake who would have incentives to push firms to compete. This explains why common ownership can lead to anti-competitive effects even if common owners do not actively intervene in firm strategy.

- There are several 'causal mechanisms' explaining why common ownership can lead to anti-competitive effects. Managers are more likely to slack. Top management pay is likely to be less sensitive to firm performance. Activist hedge funds will have reduced odds of successfully launching a campaign to improve firm performance. Some common owners have actively encouraged their firms to compete less. And managers may simply be inclined to compete less if they realise this is in their shareholders' interests.

- Data on the extent of common ownership in Australia (and many other countries) is patchy and this hinders evidence-based policy making. We propose a simple solution.

We will now go on to develop these points and several related points. We note that our contribution does not provide an exhaustive overview of all aspects of the common ownership debate. We simply want to draw your attention to some issues that are being hotly debated in academic and policy circles. Where possible, we have sought to present several sides of the argument, such that your Committee can give the important issue of common ownership the nuanced consideration it deserves. If you wish to read an exhaustive overview of the academic literature on common ownership and its effects on competition, please refer to scholarship by one of us.[1]

1. The extent of capital concentration and common ownership of public companies, and its likely future trajectory in Australia

Data on who holds shares in which Australian companies is patchy, like in many other countries. This makes it difficult to comment on the extent of common ownership[2] in Australia. Researchers need to rely on a combination of databases that require time-consuming reconciliation and data cleaning. One duo of researchers that recently undertook this exercise for Australia is Andrew Leigh and Adam Triggs. In a working paper they analyse ownership patterns in 443 Australian industries.[3] Their paper shows that 31% of firms in their sample share a substantial shareholder with at least one rival.[4] They also show that if one uses classic measures of industry concentration, which only focus on market shares and do not take common ownership into account, the true extent of the concentration of many industries is vastly underestimated, including in the commercial banking, general insurance, explosives manufacturing, plaster product manufacturing, liquor retailing, and copper ore mining industries, to name but a few. When accounting for common ownership, these industries are at a level of concentration that would concern most antitrust authorities around the world.[5]

Common ownership in Australia is likely to increase in years to come. OECD data shows that more than a quarter of shares in Australian listed companies are held by institutional investors[6], comprising mostly mutual funds, pension funds and insurance companies.[7] Such institutional

[1] Martin C Schmalz, ‘Common-ownership concentration and corporate conduct’ (2018) 10 Annual Review Financial Economics 413; Martin C Schmalz, ‘Recent Studies on Common Ownership, Firm Behavior, and Market Outcomes’ (2021) 66 Antitrust Bulletin 12. See also Einer Elhauge, ‘How Horizontal Shareholding Harms Our Economy—And Why Antitrust Law Can Fix It’ (2020) 10 Harvard Business Law Review 207.

[2] As this is the first time we have used the term ‘common ownership’ in the body of this submission, we should like to clarify that we prefer the term ‘horizontal shareholding’, which refers to the fact pattern where the same shareholders hold shares in multiple horizontal competitors. When the term ‘common ownership’ is used, it is usually horizontal shareholding that is referred to. However, when the same shareholders invest in multiple firms active at different levels of the supply chain, these firms are also ‘commonly owned’. Throughout this contribution we will use the term ‘common ownership’ to refer to horizontal shareholding, to be consistent with your terms of reference. When we mean vertical shareholding we will use that term.

[3] Andrew Leigh and Adam Triggs, ‘Common Ownership of Competing Firms: Evidence from Australia’ (2021) CESifo Working Papers 9018/2021 <https://www.cesifo.org/en/publikationen/2021/working-paper/common-ownership-competing-firms-evidence-australia>.

[4] Ibid., 14.

[5] Ibid., 15 – 18.

[6] Adriana De La Cruz, Alejandra Medina and Yung Tang, ‘Owners of the World’s Listed Companies’ (2019) OECD Capital Market Series, 37.

[7] Ibid., 6.

investors increasingly adopt passive investment strategies, whereby they track an index of shares (e.g. the ASX200 or industry-specific indices).[8] Competitors are often part of the same index, such that an increase in index investing leads to an increase in common ownership – and as institutional investment and index investing have globally been on the rise the past decades[9], the likely future trajectory of common ownership in Australia is an increasing one.

To be clear, index investing, as such, is not a problem. Only to the extent it leads to an increase in common ownership it is problematic. The market for index fund investing is, however, likely to develop towards concentration, which, in turn, is likely to lead to a further increase in common ownership. There are at least three reasons that underpin this trend towards concentration.[10] First, index investing is a scale business. Infrastructure, brokerage, marketing and management costs do not increase proportionately to the assets under management, so being big is an advantage, making it easier for big players to become even bigger. Second, within index funds there is an increase in the offer of exchange-traded funds (***ETFs***): index funds which are traded on a stock exchange themselves. Investors in ETFs will not only consider management fees when selecting ETFs, but also the ease with which they will be able to sell later on (i.e. the liquidity of the ETFs). This trend towards ETFs again favours investment advisers that have already acquired scale, because their products are more liquid. Third, it is easy for index incumbents to replicate popular challenger products, making it hard to challenge incumbents.

A distinct trend is that pension funds increasingly seem to outsource the management of their pension assets to large investment advisers. We are not aware of comprehensive data[11], but based on anecdotal evidence such outsourcing is potentially vast.[12] As this trend continues, more and more shares will be managed by the same investment advisers, who are selected based on their performance, and they will perform better if the firms of which they manage shares (on behalf of their pension fund clients) compete less.

While we can be quite certain about general trends and future developments, it remains hard to comment on the current extent of common ownership in Australia due to a lack of comprehensive, accurate and easily accessible data. In this regard, Leigh and Triggs note a range of difficulties in obtaining data on common ownership in Australia, including: investors

[8] Ibid., 21 – 22; See also Lucian Bebchuck and Scott Hirst, 'The Specter of the Giant Three' (2019) 99 Boston University Law Review 721; and John C Coates, 'The Future of Corporate Governance Part 1:The Problem of Twelve' (2019) Harvard Public Law Working Paper No. 19-07 (commenting generally on the global shift towards index investing).
[9] Bebchuck and Hirst (n 8), 737 – 741.
[10] See Bebchuck and Hirst (n 8), 729 – 731; Coates (n 8), 12 – 13; see also Laurence D Fink and Barbara G Novick, 'Trends in global asset management: the rise of index investing' (2018) Banque de France Financial Stability Review 49, 50.
[11] The author of one of the most recent works on this topic also notes this data limitation: P M Vasudev, *Beyond Shareholder Value* (Edward Elgar 2021), 58.
[12] See e.g. BlackRock, *2020 Annual Report*, 6 ("BlackRock is among the world's largest managers of pension plan assets with $3.0 trillion, or 66%, of long-term institutional AUM managed for defined benefit, defined contribution and other pension plans for corporations, governments and unions at December 31, 2020"); Chris Flood and Josephine Cumbo, 'British Airways transfers pension assets worth £21.5bn to BlackRock' *Financial Times* 2 June 2021.

are not required to disclose all their shareholdings; available databases contain errors; and the best available data is organised according to broad industry classifications, whereas a more accurate analysis would use market definitions which focus on the extent to which products are substitutable with each other within relevant geographic areas.[13]

These problems are not unique to Australia[14], but they are fundamental to enable policy makers to adopt evidence-based policies. To meaningfully gauge the true extent of common ownership in a market, one needs reliable data on approximately the largest 20 shareholders of each firm competing on that market. The most straightforward way to solve these problems is by requiring each registered company to maintain an up-to-date and publicly available share register. Such an obligation should be incumbent on each publicly listed company and private companies of an appropriate size. With regard to publicly listed companies, the share register could be maintained by the stock exchange and updated automatically with sufficient regularity. For private companies, investors should notify the company they invested in whenever they sell shares and to whom. Shareholdings should be consolidated at the level of the investment adviser, which usually votes all shares held by the individual investment vehicles it advises as one block (e.g. BlackRock as a whole) and not at the level of individual investment vehicles (e.g. individual BlackRock funds).[15] Such a share register, combined with the established body of market definition precedent of the Australian Competition and Consumer Commission (the ***ACCC***) and other competition agencies, would go a long way in informing policy and research.

2. The influence of capital concentration and common ownership on markets, including on investment decisions, market behaviour, competition and any other relevant factors

To understand why common ownership can influence market behaviour and competition, imagine an industry with two firms of the same size. Firm A decides to undercut firm B's price to attract more customers. Firm A now sells at a lower price, but makes a higher profit because it acquired some of B's customers. However, firm A's increased market share comes at the expense of firm B's market share. Average prices in the market will also be lower. As a result, firm B loses more profit than firm A gains (but customers win).

Investors in firm A will normally be satisfied with this result, because they walk away with a higher profit. But if investors hold sizeable stakes in both firms A and B, firm A's actions have caused their overall (i.e., portfolio) profits to drop because the sum of firm A's and firm B's profits is lower than before. Such 'common owners' (also called 'horizontal shareholders'),

[13] Leigh and Triggs (n 3), 9 – 13.
[14] Schmalz, Common-ownership concentration (n 1), 426 – 428.
[15] Today most investment advisers, including BlackRock, Vanguard and State Street, allocate voting responsibility to a centralised stewardship group that votes shares on behalf of all the funds they advise. See Sean J Griffith, 'Opt-in Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority' (2020) 98 Tex L Rev 983, 1001 (Griffith also reviews other investment advisers' centralisation policies).

who have invested in each horizontal competitor, have reduced incentives to encourage the two firms to compete aggressively.[16]

A key point which we are keen to emphasise at this juncture, and which we will discuss in some more detail below, is that the default model is not that firms will compete. Only if firms have the right incentives they will compete, and such incentives can come from shareholder pressure. Common owners, however, have reduced incentives to push the firms they have invested in to compete, or they at least take the place of potential undiversified shareholders with a larger stake who would have incentives to push firms to compete. This explains why common ownership can lead to anti-competitive effects even if common owners do not actively intervene in firm strategy.

Recent empirical papers do indeed demonstrate that significant common ownership in certain markets has led to anti-competitive effects, such as: increased prices in the U.S. airline[17], commercial banking[18], and seed[19] markets; delayed entry of generic products on pharma markets[20]; an increase in 'pay-for-delay' agreements between branded and generic pharma companies[21]; and an increase in the market power of beverage manufacturers active in Europe[22]. Common ownership also leads to top management pay becoming less sensitive to firm performance, meaning management will exert less effort to cut costs and innovate (a deadweight loss to society and not just a redistribution of consumer surplus to suppliers).[23] Some of these papers have been disputed, but they have all withstood critical examination, be it from a robustness, causality, statistical, data quality or other methodological perspective.[24]

[16] Julio Rotemberg formally modelled this intuitive example nearly four decades ago. He developed an economic model for firms interacting on imperfectly competitive product markets where investors hold shares in several symmetric competitors. Rotemberg's model shows that, as investors diversify more, industry output falls towards the monopolistic level, and will be at the monopolistic level when investors hold equal shares in all symmetric firms. See Julio Rotemberg, 'Financial transaction costs and industrial performance' (1984) Sloan School of Management Working Paper No. 1554-84, 12 <https://dspace.mit.edu/handle/1721.1/47993>. Also see Jose Azar, Martin C Schmalz and Isabel Tecu, 'Anticompetitive Effects of Common Ownership' (2018) 73 Journal of Finance 1513, 1521.
[17] Azar, Schmalz and Tecu (n 16).
[18] José Azar, Sahil Raina, and Martin Schmalz, 'Ultimate Ownership and Bank Competition' (2019) SSRN <https://ssrn.com/abstract=2710252>, 20.
[19] Mohammed Torshizi and Jennifer Clapp, 'Price Effects of Common Ownership in the Seed Sector' (2021) 66 Antitrust Bulletin 39.
[20] Melissa Newham, Jo Seldeslachts and Albert Banal-Estanol, 'Common Ownership and Market Entry: Evidence from Pharmaceutical Industry' (2019) SSRN <https://ssrn.com/abstract=3194394>.
[21] Jin Xie, 'Horizontal Shareholdings and Paragraph IV Generic Entry in the U.S. Pharmaceutical Industry' (2021) 66 Antitrust Bulletin 100.
[22] Nicoletta Rosati, Pietro Bomprezzi, Massimiliano Ferraresi, Annalisa Frigo and Michela Nardo, 'Common Shareholding in Europe' (2020) European Commission Joint Research Centre Technical Report, 174.
[23] Miguel Antón, Florian Ederer, Mireia Giné and Martin C Schmalz, 'Common Ownership, Competition, and Top Management Incentives' (2021) SSRN <https://ssrn.com/abstract=2802332>.
[24] The paper on the U.S. airline industry was the first empirical paper and attracted most criticism – for an overview of the main critical articles and rebuttals of each of them, see Jose Azar, Martin C Schmalz and Isabel Tecu, 'Research on the Competitive Consequences of Common Ownership: A Methodological Critique' (2021) 66 Antitrust Bulletin 113. The paper on the U.S. commercial banking sector also attracted criticism – for an overview of the main critical articles and rebuttals of each of them, see Elhauge (n 1).

While there is some data on the extent of common ownership in Australia (see above), we are not aware of specific studies that focus on the effects of common ownership on competition in Australia. We can therefore only encourage you to commission such studies. Our recommendation would be to focus on oligopolistic industries, where the negative effects of common ownership are likely to be the most pervasive. The ACCC could then take enforcement action off the back of those.

3. Any related consequences that flow from capital concentration and common ownership, including international experiences

Common ownership has been linked to a multitude of societal and corporate governance developments. We have reviewed anti-competitive effects in the previous section. In this section we focus on two additional effects which are high on the global policy agenda: climate change, and research and development expenditure.

Climate change

Some institutional investors have such extensive portfolios that they are diversified across the entire economy. For instance, in early 2020 six shareholders held 24% of Exxon Mobil and 26% of Chevron, who together are responsible for 2% of annual global greenhouse gas emissions. Those same six shareholders held similarly sized-stakes in two of the world's largest food and beverage firms, PepsiCo and General Mills, who are highly exposed to the negative impacts of climate change (temperature rises, extreme weather events, droughts, decreased labour productivity).[25]

Such broadly diversified institutional investors, it is argued, are concerned about climate change because it poses a systemic risk for a significant proportion of their portfolio companies. The risk is systemic, so it cannot be diversified away. Institutional investors therefore have a financial interest to take action to reduce global carbon emissions, including those emissions generated by the fossil fuel companies they have invested in.[26]

The argument has been made that recent climate pledges of the oil majors should be seen in this context. Even though Royal Dutch Shell's CEO was initially opposed to reducing the company's carbon footprint, in December 2018 Shell pledged to reduce its net carbon footprint with 20% by 2035, and 50% by 2050. Shell made the announcement together with a large

[25] Madison Condon, 'Externalities and the Common Owner' (2020) 95 Wash L Rev 1, 10 – 11. The six shareholders are BlackRock, Vanguard, State Street, Northern Trust, Bank of America and Capital Research Global Investors.
[26] Condon (n 25) 7, 17 – 18; John C Coffee, 'The Future of Disclosure: ESG, Common Ownership, and Systematic Risk' (2020) SSRN 10 – 12; 28.

group of institutional investors, which shortly thereafter sought similar commitments from the other oil majors, including Exxon Mobil and Chevron.[27]

The profits of oil companies are directly linked to their carbon output. If they commit to reduce carbon output, they need to change product market strategies in a way that is inconsistent with profit maximisation. By putting pressure on the oil majors to decrease carbon emissions, institutional investors had a direct impact on firm-specific product strategies, in a way that diminished the profits of some of their fossil fuel portfolio companies to the advantage of firms in other sectors they invest in.[28]

Research and development expenditure

Another strand of research predicts that common ownership can lead to increased investment in markets where R&D is important but is often discouraged by those markets' propensity for technology spill-overs.[29] Empirical evidence suggests that this effect can be either positive or negative.

One empirical paper shows that if product market spill-overs are high (as may be the case between horizontal competitors), common ownership is more likely to lead to a reduction in innovation. If technology spill-overs are high relative to product market spill-overs, common ownership is more likely to lead to more R&D.[30]

Another empirical paper shows that in high-tech industries common ownership leads to both more innovation and higher mark-ups. In low-tech industries, however, common ownership only leads to increased mark-ups.[31] According to the methodology adopted in this paper, the pharmaceutical industry, computer and optical products, and the aircraft and spacecraft manufacturing industries are examples of high-tech industries and the food, beverages, tobacco, wood and paper, and furniture industries are examples of low-tech industries.[32]

---

[27] Condon (n 25), 2 – 3; 20 – 21.

[28] Condon (n 25), 31 – 35. Some institutional investors have even publicly admitted that their firm-specific climate interventions originate from their portfolio perspective. A group of seventy-four investors controlling $4.5 trillion in assets recently outlined their expectation that portfolio companies refrain from lobbying against carbon regulation, in service to "the long-term value in our portfolios across all sectors and asset classes." (Swedish National Pension Fund and Church of England Pensions Board, 'European Investor Expectations on Corporate Lobbying on Climate Change' (2018) 2 <https://www.churchofengland.org/sites/default/files/2018-10/Investor.Expectations.Climate.Lobbying.Oct_.2018.pdf>; cited by Condon (n 25), 7.) UBS also explained in an investment white paper that because climate change is the greatest systemic risk faced by its assets, it uses its engagements with fossil fuel companies "as a means of addressing large negative externalities". (Francis Condon and Valeria Piani, 'Collaborating for a low-carbon world' (2019) 2 <https://www.ubs.com/global/en/asset-management/insights/sustainable-and-impact-investing/2019/climate-engagement.html>; cited by Condon (n 25), 35 – 36).

[29] Angel Luis Lopéz and Xavier Vives, 'Overlapping Ownership, R&D Spillovers, and Antitrust Policy' (2019) 127 Journal of Political Economy 2394.

[30] Miguel Anton, Florian Ederer, Mireia Giné and Martin Schmalz, 'Innovation: the bright side of common ownership?' (2021) SSRN <https://ssrn.com/abstract=3099578>, 20.

[31] Alexandra J Gibbon and Jan Philip Schain, 'Rising Markups, Common Ownership, and Technological Capacities' (2021) SSRN https://ssrn.com/abstract=3622912, 33, 34.

[32] Gibbon and Schain (n 31), 31 – 33.

Comment

There are two conclusions to be drawn from the above evidence. Firstly, common ownership need not necessarily have a negative welfare impact in each industry. Secondly, the evidence above further shows that common ownership impacts firm behaviour. Some still deny outright that common ownership can influence firm behaviour when it comes to anti-competitive effects (see Section 7 below), while touting that they can influence firm behaviour when it comes to positive welfare effects.[33] However, the claims that (i) common ownership can lead to positive welfare effects by changing individual firms' behaviour and (ii) that it is impossible for common ownership to have an influence on firm behaviour when it comes to anti-competitive effects are incompatible. If there can be an impact on firm behaviour in the first scenario, why couldn't there be in the second scenario?

4. The changing influence between individual investors and small funds, compared to larger funds, as a result of capital concentration and common ownership

The largest investment advisers are likely to become even bigger and crowd out smaller investment advisers, to such an extent that American scholars refer to the 'Specter of the Big Three'. The reasons for this likely trajectory are summarised in Section 1 and how this can affect competition is set out in Section 2. There are two additional points we would like to touch upon in this section.

Firstly, some have made the argument that when there are large undiversified investors in a firm, in addition to common owners, this may cause friction regarding which objectives a firm should pursue. Common owners have reduced incentives to actively push for aggressive competition, because if one firm does well it usually does so at the expense of its competitors. Undiversified investors might however prefer that the firm they have invested in competes aggressively against other firms to gain market share. Faced with shareholders who have conflicting interests, the argument goes, firms will revert to strategies that focus on individual firm profit maximisation.[34]

This is not the place to discuss in detail why there is little theoretical or empirical merit to this claim.[35] We simply note that this claim is inconsistent with the work of Nobel Laureate Oliver Hart, who shows that only in a very limited set of circumstances firms will focus on profit maximisation of their own accord.[36] In all other circumstances there is no clear single objective

[33] See, for instance, BlackRock's 2021 client letter: "We engage with companies regarding governance and sustainable business practices that we believe promote durable, long-term profitability." and "[…] we are explicitly asking that all companies disclose a business plan aligned with the goal of limiting global warming to well below 2ºC."
[34] Edward B Rock and Daniel L Rubinfeld, 'Antitrust for Institutional Investors' (2018) 82 Antitrust L.J. 221, 236.
[35] For a summary of the relevant economic literature on objectives of the firm, see Schmalz, Common-ownership concentration (n 1), 419 – 424.
[36] Oliver D Hart, 'On Shareholder Unanimity in Large Stock Market Economies' (1979) 47 Econometrica 1057. One of the conditions that must hold is that firms act on perfectly competitive markets, which is clearly not the case for the markets studied by the papers reviewed in Section 2.

which firms will pursue. We also note that the empirical basis for the argument that firms will revert to profit maximisation strategies because there is some supposed conflict between the interests of their shareholders will become increasingly untenable, as individual investment funds are increasingly crowded out by the 'Big Three' (for reasons discussed in Section 1) and common ownership increases accordingly.

Secondly, if one views hedge fund activism as improving individual firm performance and therefore welfare-enhancing[37], common ownership will have a second-order welfare-decreasing effect by reducing the success rate of activist campaigns. Hedge funds sometimes advocate for a more aggressive competitive strategy at their portfolio companies, but due to their small stakes they need to rely on the support of larger institutional investors (who are often common owners) for their proposals to get traction with management.[38] Common owners have withheld their support for such activist campaigns in circumstances suggesting that the reason for doing so is that a more competitive strategy at one firm would reduce the value of their investments in competing firms.[39] With common ownership on the rise, activist hedge funds may increasingly struggle to successfully implement their strategies at portfolio firms.

5. The role of regulators in responding to these consequences

As discussed in Section 1, there is a trend towards index investing and a concentrated set of investment advisers will increasingly dominate the institutional investment sector, leading to more common ownership. As index investing is a scale business and challenger products can be replicated easily, it is unclear how the market could self-correct. The onus is therefore on regulators to solve the problems identified above.

The first main role of legislators and regulators is building the necessary regulatory infrastructure to generate high quality data for legislators and enforcement agencies. A change to the share register, as set out above, would be a very important step in this regard. Pending such a regulatory change, the ACCC might already be able to use its market study powers to map exact shareholding structures in certain industries and consider appropriate enforcement action off the back of that. It could also already analyse and take into account industry-wide shareholding patterns when reviewing mergers and acquisitions, as the European Commission has done.[40]

---

[37] In support of this claim, see e.g. Lucian A Bebchuck, 'The Myth that Insulating Boards Serves Long-Term Value' (2013) 113 Colombia Law Review 1637, 1669 – 1673. *Contra*: see e.g. Leo E Strine, 'One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?' (2010) 66 The Business Lawyer 1.
[38] Alon Brav, Wei Jiang, Tao Li and James Pinnington, 'Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests' (2021) ECGI Finance Working Paper N° 601/2019 <https://ssrn.com/abstract=3101473>.
[39] Martin Schmalz, 'How Passive Funds Prevent Competition' (2015) <http://ericposner.com/martin-schmalz-how-passive-funds-prevent-competition/> (commenting on Trian's lost proxy fight at global agrochemical company DuPont).
[40] European Commission decision of 27 March 2017 in *Dow/DuPont* (Case M. 7932); European Commission decision of 21 March 2018 in *Bayer/Monsanto* (Case M. 8084).

The second main role of legislators and regulators it to take appropriate enforcement action. We turn to this next.

6. Policy responses to address these consequences, including by government, regulators and public companies

We have not yet given sufficient consideration to all the merits and demerits of policy proposals to remedy the anti-competitive effects of common ownership. This is the focus of ongoing research by one of us. We will therefore refrain from commenting on their adequacy and simply provide a high-level outline of the two categories into which current policy proposals can generally be grouped and some of the main issues that have been raised. The first category comprises proposals to apply existing competition law to common ownership. The second category comprises proposals for new regulation. All these proposals have been made with reference to EU and U.S. law.

Some have suggested that the current competition law toolbox (antitrust rules and merger control regulation) can be applied to prevent or repress the anti-competitive outcomes of common ownership. If one seeks to achieve full prevention by applying current competition law, this would require applying mandatory merger control rules to common ownership. Some argue this is impossible because common owners do not have 'control', while others maintain that they have a form of joint control and that merger control rules can therefore apply. [41] This is currently a moot point in Australia, because under Australian merger control rules filings are in any case voluntary.

However, in light of the current debate about reforming Australia's merger control law and moving to a mandatory regime[42], we do want to point out that in 2014 the European Commission issued a discussion paper on whether the EU's Merger Regulation (which requires mandatory notification of the acquisition of controlling shareholdings in firms with a sufficiently large turnover) should be expanded to capture non-controlling minority shareholdings.[43] In a recent policy paper the European Commission confirmed it is no longer considering such an expansion.[44] We want to draw the Committee's attention to the fact that the European Commission's 2014 paper did not focus on common ownership, but on other theories of harm linked to minority shareholdings.[45] The Commission's 2021 policy paper does not comment on common ownership either, as this was beyond the scope of the Commission's inquiry. It is therefore unclear whether the Commission's thinking is that it

[41] See for instance Elhauge (n 1), 255 – 284 (arguing that current EU antitrust law and merger control law applies to horizontal shareholding, and that horizontal shareholding should also be a factor in merger assessments); Cf. Burnside and Kidane, 27 – 52 (disputing Elhauge's arguments regarding EU law); Douglas H Ginsburg and Keith Klovers, 'Common sense about common ownership' (2018) 2 Concurrences, paras 28 – 47 (disputing Elhauge's arguments regarding U.S. law).
[42] Rod Sims, 'Protecting and promoting competition in Australia', speech of 27 August 2021 <https://www.accc.gov.au/speech/protecting-and-promoting-competition-in-australia>.
[43] European Commission, 'White Paper: Towards more effective EU merger control' COM (2014) 449 final.
[44] European Commission, 'Staff Working Document: Evaluation of procedural and jurisdictional aspects of EU merger control' SWD (2021) 66 final.
[45] See Section 3.3.1 of the Commission's White Paper (n 43).

would be disproportionate to expand the EU Merger Regulation to capture the acquisition of minority shareholdings if those would lead to an increase in common ownership. In recent merger control decisions, when reviewing the acquisition of controlling shareholdings, the Commission did take the level of common ownership in the relevant markets into account.[46]

Punishing (and thereby also partially preventing) anticompetitive outcomes requires applying antitrust rules. There are again two opposing views, with the debate focussing on whether there is an anticompetitive ‘agreement’ or ‘concerted practice’ between the common owners and/or the firms they invest in, and whether overlapping shareholders may make oligopolistic firms ‘collectively dominant’.[47] The EU and U.S. antitrust rules cannot apply if there is no agreement or concerted practice to be prohibited, or, as far as the EU rules are concerned, a position of collective dominance to be controlled.

Some have also questioned the adequacy of applying antitrust rules to common ownership. Antitrust enforcement is by its very nature ad hoc and, so the argument goes, might not be the most adequate remedy to solve a systemic problem.[48] Some form of regulation would be more adequate to deal with common ownership. Posner, Scott Morton and Weyl have for instance proposed that no institutional investor or individual holding shares of more than a single effective firm in an oligopoly may ultimately own more than 1% of the market share unless the entity holding shares is a free-standing index fund that commits to being purely passive.[49]

This proposal has been met with criticism from institutional investors. They argue that it would increase the cost and risk of diversified investment products, in turn undermining households’ access to low-cost diversified investments.[50] Moreover, limiting diversified funds to one company per sector “*would lead to billions of dollars of divestment from public companies by mutual funds, creating massive flows and generating substantial transaction costs*”.[51]

As to diversification and access to low-cost diversified investment, the limits to diversification are much smaller than claimed.[52] While it is true that these limited constraints on diversification will have some effect on the type of investment products available to households, one needs to bear the right context in mind. Not all households are invested in

[46] See the sources cited in footnote 40.
[47] See the sources cited in footnote 41.
[48] For a very considerate discussion, see Eric A Posner and Fiona M Scott Morton and E Glen Weyl, ‘A Proposal to Limit the Anticompetitive Power of Institutional Investors’ (2017) 81 Antitrust LJ 669, 691 - 695.
[49] Posner, Scott Morton and Weyl (n 48), 708 – 710 (for a more elaborate discussion of this proposal). They also discuss the merits and demerits of this proposal being formulated by way of legislation, formal administrative rules or an enforcement guideline (at 709). A summary of this article’s proposals was also published as an Op-ed in the New York Times: https://www.nytimes.com/2016/12/07/opinion/a-monopoly-donald-trump-can-pop.html.
[50] BlackRock, ‘Re: Competition and Consumer Protection in the 21st Century – Hearing #8’ (2019) Position Paper for FTC Hearing, 2 and 20.
[51] BlackRock (n 50), 3.
[52] Posner, Scott Morton and Weyl (n 48), 710 – 712.

mutual funds or pension funds, while the negative effects of common ownership are borne by all, including by those that do not have sufficient disposable income to invest.[53]

As to the effect on the stock market, this has not been modelled with precision, but Posner, Scott Morton and Weyl do point out that for every share that is sold there will in principle also be a buyer. The market should therefore, eventually, balance out. There would also be an opportunity for smaller institutional investors to enter the market, creating more competition at this level of the investment chain. Finally, there is also the more fundamental point that current equity values reflect oligopoly power created by common ownership, so any reductions in the share price caused would simply reset the value of the shares at a more competitive level.[54]

This section concludes our contributions to your terms of reference. We would now like to make some additional comments. While institutional investors have certain virtues, they also have vested interests to protect. You should expect to receive several simplistic or vague arguments intended to muddy the waters, as was the case with the U.S. Federal Trade Commission and the Organisation for Economic Cooperation and Development when they conducted their inquiries.[55] We would therefore like to suggest some lines of inquiry you may wish to pursue as you engage with institutional investors' arguments. These are all linked to your second term of reference, the influence of common ownership on markets and competition.

7. The argument that there is no clear causal mechanism through which common ownership causes anti-competitive effects

One claim that is often made is that even if correlation between common ownership and anticompetitive effects can be shown, there is no clear causal mechanism through which such effects occur.[56] This makes the causal nature of the established correlation implausible or it would at least make potential enforcement action imprecise and therefore unwarranted. During the U.S. FTC Hearing on common ownership, Commissioner Philips said in his opening remarks *"…areas of research that I, as an antitrust enforcer, would like to see developed before shifting policy on common ownership [are]: Whether a clear mechanism of harm can be identified…"*.[57]

---

[53] Fiona Scott Morton and Herbert Hovenkamp, 'Horizontal Shareholding and Antitrust Policy' (2018) 127 Yale L J 2026, 2040.
[54] Posner, Scott Morton and Weyl (n 48), 716 – 717.
[55] OECD, 'Common ownership by institutional investors and its impact on competition' (2017) <https://www.oecd.org/competition/common-ownership-and-its-impact-on-competition.htm>; U.S. FTC, ' FTC Hearing #8: Common Ownership' (2018) <https://www.ftc.gov/news-events/events-calendar/ftc-hearing-8-competition-consumer-protection-21st-century>.
[56] As to investors, see e.g. BlackRock (n 50), 16 - 17; Fink and Novick, (n 10) 59; As to scholars, see e.g. Rock and Rubinfeld (n 34), 247 – 251; Ginsburg and Klovers (n 41) para 6.
[57] Noah Joshua Phillips, 'Corporate Governance, Institutional Investors, and Common Ownership' (2018) FTC Hearing #8: Competition and Consumer Protection in the 21st Century <https://www.ftc.gov/news-events/events-calendar/ftc-hearing-8-competition-consumer-protection-21st-century>, 4.

Recent scholarship however gives an overview of potential causal mechanisms and supporting evidence.[58] These mechanisms include:

- Managerial slack: competing requires significant managerial effort (it requires, amongst others, finding ways to improve products, reduce cost and build a brand) and managers may simply not want to do this unless they are pushed by shareholders. Common owners however have reduced incentives to push managers to compete, as it usually reduces their overall portfolio profits, or they at least take the place of potential undiversified shareholders with a larger stake who would have incentives to push firms to compete.[59]

- Executive compensation: theoretical and empirical evidence shows that common ownership leads to top management pay becoming less sensitive to firm performance, meaning management will exert less effort to cut costs and innovate.[60]

- Withholding support for activist hedge fund campaigns: as explained above (Section 4), common owners may withhold their support from activist hedge funds advocating for a more aggressive competitive strategy at their portfolio companies.

- Direct communications: the general press has recorded several instances of common owners openly telling their portfolio companies to compete less.[61] These instances are rare, because such communications very easily fall foul of prevailing antitrust rules, but it does beg the question how many similar but unrecorded communications there might be. Common owners are known to have frequent informal meetings with their portfolio companies.[62]

- Acting in the interests of common owners: if managers and directors know that many of their shareholders are also invested in their competitors, they may simply be inclined to compete less.[63] Formal economic models indeed suggest that if managers care about their vote or odds of re-election, votes by common owners will incentivise managers to

[58] Einer Elhauge, 'The Causal Mechanisms of Horizontal Shareholding' (2021) 82 Ohio State Law Journal 1; Nathan Shekita, 'Interventions by Common Owners' (2020) SSRN <https://ssrn.com/abstract=3658726>.
[59] Azar, Schmalz and Tecu (n 16), 1552 – 1553.
[60] Antón, Ederer, Giné and Schmalz (n 23), 15 – 27. To be clear, the theoretical model developed in this paper does not assume or imply that horizontal shareholders [common owners] design management compensation packages with this goal in mind. They are simply willing to tolerate more managerial slack and the resulting productive inefficiency.
[61] For an overview, see Shekita (n 58), 2 – 3.
[62] For instance, BlackRock had 3,500 'engagement meetings' with more than 2,000 unique companies in 2020: BlackRock, *Investment Stewardship Annual Report 2020*, https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020-calendar-year.pdf, 10.
[63] Alexander I Platt, 'Beyond "Market Transparency": Investor Disclosure and Corporate Governance' (forthcoming, 2022) 74 Stanford Law Review, pages 61 – 62 of manuscript <https://ssrn.com/abstract=3906360>. Managers and directors of listed firms would typically know who their shareholders and those of their competitors are under existing securities regulation, e.g. pursuant to '13F filings' under U.S. securities law. See Platt (n 63), 61.

compete less.[64] Acting in the interests of common owners may moreover increase directors' odds of obtaining additional directorships, as common owners will often be leading shareholders of many other firms.[65] If firms do not act in the interests of their shareholders, those shareholders may also express their displeasure by selling shares. Such shareholder exits reduce the share price and value of corresponding equity-based management compensation.[66]

This non-exhaustive summary shows that there are in fact a host of plausible causal mechanisms through which the competitive strategy of individual firms is or can be affected by common owners.[67] We therefore invite you to critically interrogate anyone claiming that there is no plausible causal mechanism.

8. The argument that fiduciary duties of portfolio companies make any effects of common ownership on competition implausible

Critics of common ownership theories of harm regularly argue that the fiduciary duties incumbent on the management and directors of portfolio companies towards shareholders "as a class" make causality between common ownership and anticompetitive effects implausible. In short, the argument goes as follows. While common owners have reduced incentives to push their portfolio companies to compete aggressively and focus on individual profit maximisation, undiversified shareholders have higher incentives to do so. Managers and directors are however legally obliged to act in the interests of all shareholders, and not just a subset of shareholders, failing which they violate their fiduciary duties. It follows that firms will not take actions that favour common owners at the expense of undiversified shareholders. Any anticompetitive effects stemming from common ownership are thereby rendered implausible.[68]

Fiduciary duties are, however, unlikely to put any real constraint on management and directors in this context.[69] Firstly, "fiduciary duties" are a broad-brush legal concept, which gives managers and directors significant discretion in deciding how to act. It is generally very hard to determine when a breach has occurred and this is only made more difficult if the actions taken were also in the interests of the undiversified shareholders (see Section 2). Secondly, courts reviewing a claim for breach of fiduciary duties will generally be cautious to intervene,

---

64 Jose Azar, 'Portfolio Diversification, Market Power, and the Theory of the Firm' (2017) SSRN <https://ssrn.com/abstract=2811221>.
65 Elhauge (n 58), 21.
66 Elhauge (n 58), 20.
67 For a more exhaustive summary, see the sources cited in footnote 58.
68 See, for instance, BlackRock (n 50), 15 ("First, and most fundamentally, this assumption would mean that executives of a particular airline are willing to sacrifice their company's profits to advance the purported objectives of a subset of their shareholders who are common holders of competitors. Doing so would be in direct violation of their fiduciary duties to the company."); See also, for instance, Menesh S Patel, 'Common ownership and antitrust: eight critical points to guide antitrust policy' (2019) May CPI Antitrust Chronicle 9, 11; Thomas A Lambert and Michael E Sykuta, 'The Case for Doing Nothing about Institutional Investors' Common Ownership of Small Stakes in Competing Firms' (2019) 13 Vir. L.R. 213, 236.
69 See, in a similar sense: OECD Secretariat, 'Common Ownership by Institutional Investors and its Impact on Competition: Background Note by the Secretariat' (2017) DAF/COMP(2017)10, para 80.

even when it comes to (subtle) breaches of the duty of loyalty. Thirdly, assuming it is possible for an individual undiversified shareholder to sue[70], they may not have the incentives to do so. If the action complained about did put the undiversified shareholder at a monetary disadvantage, any compensation will go to the company and shareholders will only enjoy indirect compensation, in proportion to their shareholding.

This is not the place to provide an answer to these questions.[71] Our point is simply that fiduciary duties are not as likely to be put a constraint on management and directors in this context, and that the argument that fiduciary duties prevent any anti-competitive effects arising from common ownership is not as persuasive as it may seem. We therefore invite you to critically interrogate anyone making this argument.

9. The argument that common owners' vertical investments make horizontal effects implausible

Another argument that one often hears in the common ownership debate is that institutional investors would not have an incentive to pursue anti-competitive effects (or at least not have reduced incentives to push firms to compete), because companies up and down the supply chain or in related markets, in which institutional investors also have stakes, would simply bear the cost of these anti-competitive effects. For instance, an investor may hold shares in certain airlines, but also in Expedia (a major retailer of airlines tickets), Boeing (a manufacturer of commercial aircraft), United Technologies (an aircraft engine producer), AAR Corp (the largest U.S. provider of commercial aircraft maintenance and repair services), Hertz (an automobile rental company) and Accenture (a consulting firm for which air travel is a significant cost component). Each of those companies is likely to perform worse when airlines limit output or price supracompetitively.[72]

Apart from the fact that this argument is inconsistent with the empirical evidence reviewed in Section 2, it also suffers from several theoretical flaws. The argument is contradictory; it ignores the fact that anti-competitive incentives remain if investments are asymmetric; and it is simplistic.[73]

Firstly, the argument is contradictory. If one maintains that horizontal shareholders will not pursue industry value maximisation because their vertical investments[74] would offset their incentives to do so, then the implicit premise is that institutional investors pursue portfolio value maximisation. Why is the conclusion then that they will prefer their firms to maximise

---

[70] An action for fiduciary duties against directors and management is, in principle, for the company to start. Only in a limited set of circumstances can an individual shareholder start such an action. For an overview of Australian law on this point, see Stephen Bottomley, Kath Hall, Peta Spender and Beth Nosworthy, *Contemporary Australian Corporate Law* (2nd edn Cambridge University Press 2020), Chapter 14.
[71] Ongoing research by one of us will develop and address these questions more fulsomely.
[72] Thomas A Lambert and Michael E Sykuta (n 68), 234 – 235; see, similarly, Ginsburg and Klovers (n 41), 36.
[73] The ideas in this section draw from ongoing research by one of us.
[74] We use 'vertical investments' as shorthand for investments in markets up and down the supply chain as well as investments in related markets.

their own value? If portfolio maximisation is the aim, then surely institutional investors should focus on strategies that maximise the joint value of all their horizontal and vertical investments.

Secondly, horizontal shareholders usually do not have similarly-sized investments in vertically related firms. Active funds may have no such investments at all. Index funds which focus on industries will have horizontal shareholdings across that industry, but will not typically invest in that industry's customers. Even a large general index fund will normally have more horizontal than vertical shareholdings, because the buyers and suppliers of the firms they invest in will often be consumers or will be below the fund's capitalisation cut-off. Consequently, horizontal shareholding is normally asymmetric across vertically related markets, meaning anticompetitive incentives remain.[75]

Thirdly, the argument is simplistic and for there to be some cogency to it, it needs to take account of network theory and passing-on theory. We briefly summarise the key tenets of both theories and how they impact the common ownership debate.

In network theory, vertical spillovers are the subject of input-output network studies. When one sector uses the output of another as an input for its production, there is an input-output link, the intensity of which is measured by the dollar value of the input used. Network theory shows that the ability of a sector to impose spillovers on neighbouring sectors and on the economy as a whole depends on the centrality of the sector.[76] For instance, industries such as 'Wholesale trade' or 'Management of companies and enterprises' are extremely central. The 'Investigation and security services' industry, on the other hand, tend to be on the periphery of the economy.[77]

In central markets, lower levels of input and output can harm other firms in institutional investors' portfolio. These cross-industry effects could lower horizontal shareholders' incentives to pursue industry profit maximisation (or give them higher incentives to push firms to compete). However, in peripheral industries, or industries that sell directly to consumers (like the airline industry), horizontal shareholders may well have incentives to pursue reduced competition (or give them lower incentives to push firms to compete).[78]

Even if one takes network theory into account, the picture is still not complete. One also needs passing-on theory to assess the merits of the argument that vertical investments offset horizontal shareholders' incentives to pursue anti-competitive effects.

Economic theory suggests that if there is an overcharge at some level of the production and supply chain, downstream firms can be expected to respond to this cost change by adjusting

[75] Elhauge (n 58), 46 – 49; Harvard Law Review Editorial, 'Vertical Shareholding' (2019) 133 Harvard Law Review 665, 676.
[76] Alessandro Romano, 'Horizontal Shareholding and Network Theory' (2020) Yale Journal on Regulation 363, 387 – 389.
[77] Romano (n 76), 387 – 388. This example draws from data of the U.S. Bureau of Economic analysis: https://www.bea.gov/industry/input-output-accounts-data.
[78] Based on Romano (n 76), 389.

their pricing behaviour to pass on (some of) the cost increase to their customers.[79] By way of example, assume that on the markets for the extraction and processing of copper ore all firms are owned by horizontal shareholders and that this has the effect of raising the price for processed copper. Assume also that on the wire harnesses market (an input market for car manufacturing) all firms are owned by the same horizontal shareholders. These firms will pay more for their input, processed copper, as a result of horizontal shareholding upstream. However, if they can pass on that overcharge in its entirety to their own customers, car manufacturers, their profit may – depending on the shape of their demand curve – not be impacted by the overcharge they paid for copper. Their shareholders, who in this example are not invested in car manufacturing companies, will also not be hurt.

This is not the place to discuss under which conditions costs can be passed down the supply chain. But the above example shows that the extent to which firms can pass on anticompetitive effects along the production and supply chain, until they are passed on to firms that are not horizontally owned or to end users, should be taken into account to assess the incentives of horizontally and vertically diversified institutional investors to pursue industry value maximisation through anti-competitive strategies.

We therefore encourage you to engage critically with arguments that institutional investors' investments in related industries (vertical or otherwise) make anti-competitive effects resulting from their horizontal investments unlikely. The argument is not as intuitive as some say it is, it is often factually wrong, and it is simplistic. Only empirical studies which take all the learnings from network theory and passing-on theory into account can determine whether there is value to the argument as far as particular markets are concerned. That is not to say that such evidence is needed to take action against horizontal shareholding. Studies of horizontal shareholding simply observe patterns and implicitly already take into account any elements, such as vertical shareholding, that might offset the anti-competitive effects of horizontal shareholding. Our point is that if one wants to dispute these empirical findings by making an argument based on vertical shareholding, one can do so, provided the argument is backed up with appropriate empirical evidence. But simply making an unsubstantiated claim in the face of empirical evidence that shows the opposite does not pass muster.

10. Comments on academic bias

Finally, we should like to draw your attention to the fact that, unfortunately, much academic research in this space is funded directly or indirectly by institutional investors, leading to conscious or unconscious bias of the authors. Other contributions may not be funded by institutional investors, but the authors still stand to gain from presenting a certain view. We therefore suggest that you ask everyone making submissions or contributing otherwise to your

[79] For a good summary of passing-on theory, see Benoît Durand, Iestyn Williams, Paul Hitchings, Iñigo Quintana, James Hain-Cole and Luis Loras, 'Study on the passing-on of overcharges' (2016) Report for European Commission.

inquiry to make a fulsome disclosure statement on funding for their contributions and related or unrelated, potential or actual, conflicts of interest.

We would like to start by making our own:

- Martin Schmalz holds a portfolio of ETFs and on the rare occasions he gives talks about the topic of common ownership to for-profit entities, he is compensated for these talks. None of his research has been sponsored. Martin does not serve on the board of institutional investors, nor does he run a research centre that is sponsored by institutional investors.

- Thomas Reyntjens' research at the University of Oxford is funded by the Law Faculty and Brasenose College. At the time of writing, Thomas is also an Associate lawyer in the London office of Freshfields Bruckhaus Deringer LLP, a London-headquartered international law firm. Freshfields has not had an opportunity to review this contribution, which is made in a personal capacity. While some of the institutional investors that are the subject of this inquiry may occasionally instruct Freshfields, Thomas does not stand to gain from such instructions, as he will leave his employment at Freshfields in October 2021 to become a full-time researcher.

*

*   *

We hope this contribution is helpful for your inquiry and we look forward to reading your report to the Australian Parliament.

Yours sincerely,

Martin Schmalz
Associate Professor of Finance
Saïd Business School and Nuffield College
University of Oxford

Thomas Reyntjens
DPhil Candidate in Law
Senior Hulme Scholar at Brasenose College
University of Oxford