

# Common Ownership, Competition, and Top Management Incentives\*

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## Abstract

This paper presents a mechanism through which common ownership affects product market outcomes. We embed a managerial incentive design problem in a model of strategic product market competition under common ownership. Consistent with empirical evidence, firm-level variation in common ownership causes variation in managerial incentives *across firms*, as well as *intra-industry cross-market* variation in prices, market shares, concentration, and output—all without communication between shareholders and firms, coordination between firms, knowledge of shareholders’ incentives, or market-specific interventions by top managers. We empirically document that managerial compensation is less performance-sensitive in firms whose investors hold greater stakes in industry competitors.

JEL Classification: M12, L13, J33, G32, D21

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*“... 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 ...”*

—FTC Commissioner Noah J. Phillips, FTC Hearing on Common Ownership, December 6, 2018

*“The organizational complexity of today’s largest public companies makes it far from clear how—even if top managers receive an anticompetitive signal from their pay packages—those incentives affect those making pricing decisions throughout the organization. [...] For these reasons, I worry that the evidence we have today may not carry the heavy burden that, as a Commissioner sworn to protect investors, I would require to impose costly limitations.”*

—SEC Commissioner Robert J. Jackson, FTC Hearing on Common Ownership, December 6, 2018

## 1 Introduction

The common ownership hypothesis suggests that when large investors own shares in more than one firm within the same industry, those firms may have reduced incentives to compete. Firms can soften competition by producing fewer units, raising prices, reducing investment, innovating less, or limiting entry into new markets. Empirical contributions document the growing importance of common ownership and provide evidence to support the theory.<sup>1</sup> Prominent antitrust law scholars (Elhauge, 2016; Scott Morton and Hovenkamp, 2017; Hemphill and Kahan, 2020) claim that common ownership “has stimulated a major rethinking of antitrust enforcement.” Indeed, the Department of Justice, the Federal Trade Commission, the European Commission, and the OECD have all acknowledged concerns about the anticompetitive effects of common ownership and have even relied on the theory and evidence of common ownership in major merger cases.<sup>2</sup>

But because managers rather than investors control firm operations and because managers may not know the extent of their main investors’ shareholdings in other firms, skepticism that common ownership affects product market outcomes may be warranted given the lack of a clear

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<sup>1</sup>Notable theoretical contributions include early work by Rubinstein and Yaari (1983) and Rotemberg (1984), as well as recent papers by López and Vives (2018), Backus et al. (2020a), and Azar and Vives (2020). Comprehensive surveys by Schmalz (2018) and Backus et al. (2019) summarize a variety of empirical studies providing market- and industry-level as well as economy-wide evidence. More recent empirical contributions include Boller and Scott Morton (2020), Newham et al. (2019), Xie and Gerakos (2020), Li et al. (2020), and Eldar et al. (2020).

<sup>2</sup>Solomon (2016) reported on an investigation based on Senate testimony by the head of the Antitrust Division, Federal Trade Commission (2018) featured a hearing on common ownership, and Vestager (2018) disclosed that the Commission is “looking carefully” at common ownership given indications of its increase and potential for anticompetitive effects. For other recent activity, see OECD (2017) and European Competition Commission (2017).

mechanism that recognizes these agency problems and informational constraints. Thus far, no paper has established a mechanism through which common ownership affects product market outcomes.<sup>3</sup> This has fueled a vigorous debate about whether existing evidence on common ownership has a plausible causal interpretation and, if it does, how to effectively address the resulting regulatory, legal, antitrust, and corporate governance challenges. In this paper we theoretically show that managerial incentives can serve as a mechanism that connects common ownership to softer competition even at the intra-industry product market level. This mechanism requires neither communication/coordination between shareholders, managers or firms nor market-level interventions by shareholders or even top managers. Our model predicts intra-industry cross-market variation in product market outcomes that is caused by firm-level variation in common ownership, in line with existing empirical evidence on prices, quantities, costs, markups, and concentration. We also empirically confirm the central prediction of our theoretical framework, that higher firm-level common ownership leads to less performance-sensitive incentives for CEOs and other top managers.

We begin our analysis by embedding a canonical managerial incentive design problem with moral hazard ([Holmstrom and Milgrom, 1987](#)) in a conventional model of strategic product market competition ([D’Aspremont and Jacquemin, 1988](#); [Kamien et al., 1992](#); [Raith, 2003](#)) with potentially diversified owners ([Rotemberg, 1984](#)). Our unified model captures the agency conflicts that exist between those who manage firms (managers) and those who own them (investors), and recognizes that large investors routinely hold ownership stakes in several firms in the same industry. The central driving force is that performance-sensitive managerial compensation encourages productivity-improving managerial effort, which in turn has two effects. First, in a setting where product prices fixed, productivity-improving managerial effort increases firm profitability and is desirable for all types of owners. Second, with endogenous product prices, productivity enhancements also increase how fiercely the firm competes in the product market. The latter channel indirectly reduces the profitability of competing firms and thus stands in conflict with the interests of common owners who hold shares in other firms in the same industry. Common owners are more willing to tolerate managerial slack and productive inefficiency at their portfolio firms, because doing so also leads to less intense competition for the other firms in which they hold

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<sup>3</sup>One exception is [Matvos and Ostrovsky \(2008\)](#) who document the effect of common ownership on shareholders’ voting behavior in mergers & acquisitions. Common owners are less likely to reject mergers, thus changing the overall market structure, which in turn may affect product market outcomes.

shares. Therefore, the model predicts a negative relationship between common ownership and the sensitivity of top management incentives to firm performance.

By allowing for asymmetries in firm-level common ownership in a multimarket industry, the model generates additional firm- and intra-industry market-level predictions. First, within the same industry more commonly-owned firms place greater weight on competitors' profits, and therefore optimally have weaker managerial incentives and compete less aggressively (i.e., set higher prices) than less commonly-owned "maverick" firms. Maverick firms place less or no weight on competitors' profits, and therefore endogenously give stronger incentives to their top managers, set lower prices, and obtain greater market shares. Second, even though top managers can only exert a single firm-wide productivity-improving effort (rather than several market-specific ones), commonly-owned firms compete less aggressively in markets in which they face other commonly-owned firms than in markets in which they face maverick firms. The model thus proves that a simple and standard firm-level corporate governance mechanism is sufficient for common ownership to affect firm behavior and product market outcomes even within the same industry. Specifically, it can cause the previously documented intra-industry market-level correlations between common ownership and product prices (positive), output (negative), and product market concentration (negative). Understanding this new mechanism is important for competition policy. It shows that due to the agency problem which prevents owners from directly controlling prices, the anticompetitive effect of common ownership may not manifest itself in higher markups but instead materializes as higher costs resulting from managerial underinvestment in productivity improvements. It also suggests that there may be no conflict in objectives between corporate governance, which seeks to improve how efficiently firms are run, and antitrust policy, which attempts to encourage vigorous competition.

Crucially, the mechanism we propose does *not* rely on (i) owners having access to sophisticated market-level incentives or communications to steer product market behavior in different markets, (ii) top managers' knowledge of the ownership structure of either their own firms or their competitors, (iii) top managers making detailed market-specific strategic choices (e.g., setting prices), or (iv) explicit or tacit collusion among managers, firms, or shareholders. Instead, our mechanism relies only on unilateral changes in the firm's objective, managers exerting firm-wide, productivity-improving effort solely based on their own explicit incentives (as in any standard corporate finance or organizational economics model), and market-level specialists making product market choices

solely based on market demand and firms’ cost structures (as in standard industrial organization models). Combining standard assumptions in corporate finance, organizational economics, and industrial organization is all that is necessary to generate the above-mentioned predictions about firm governance, managerial incentives, and product market behavior.

Although the main purpose of our theoretical is to provide a mechanism for intra-industry cross-market common ownership effects and to provide a unified explanation for a set of existing empirical results, the model also makes new testable predictions. We empirically confirm the central prediction of a negative relation between common ownership and the performance-sensitivity of top management compensation, through which the causal link between common ownership and product market outcomes is established in our model. Using theoretically informed measures of common ownership from the industrial organization literature ([Backus et al., 2020a](#); [Boller and Scott Morton, 2020](#)) that are also closely linked to our theoretical framework, we document a strong and robust negative association between a firm’s common ownership and the wealth-performance sensitivity (the most comprehensive measure of explicit incentives) of its top manager. In panel regressions, we estimate that an interquartile range shift (25th to 75th percentile) of the firm-level degree of common ownership is associated with a 6.6% reduction in CEO wealth-performance sensitivity. To put this incentive-reducing effect of common ownership in perspective, it is comparable to the effect of a one-standard deviation reduction in firm volatility on managerial incentives. This result remains robust to using various alternative measures of managerial incentives, common ownership, and industry definitions. Across all dimensions (i.e., managerial wealth-performance sensitivities, common ownership measures, and industry definitions) of the full matrix of robustness checks, our results remain consistently negative, with similar (or even larger) economic magnitudes and statistical significance levels.

Whereas managerial incentives, productivity improvements, competitive actions, market shares, and profits are endogenously determined in our model, firm ownership is assumed to be exogenous. We therefore need to address the empirical concern that endogenous ownership confounds the interpretation of the negative correlation between common ownership and managerial incentives reported in our panel regressions. Specifically, we employ a difference-in-differences design to investigate whether the negative relationship between the strength of managerial incentives and common ownership is also present when we only use the variation in common ownership from additions of industry competitors to the S&P 500 index. In this design, treated companies are

index incumbents (i.e., firms that are already in the S&P 500 index) who experience the addition of an industry competitor to the index. The ownership of these treated companies is unaffected. The only thing that changes is that their shareholders also hold larger stakes in the firms’ industry competitors following the index addition of these competitors. In other words, index additions of competitors increase the shareholder profit weights of treated index incumbents but do not change their ownership structure. Following the inclusion of industry competitors in the S&P 500, the treated index incumbents experience a significant increase in the portfolio weights their owners attach to rival profits and the compensation of their top managers becomes significantly less sensitive to their firms’ performance. This negative effect on CEO wealth-performance sensitivity is gradual: it is not present before the inclusion of the competitor into the index and increases in magnitude over time following the index inclusion event.

An ample body of theoretical work, beginning with [Hart \(1983\)](#), [Vickers \(1985\)](#), [Fershtman and Judd \(1987\)](#) and [Sklivas \(1987\)](#), examines the relationship between product market competition and managerial incentives.<sup>4</sup> The earliest investigation of the idea that shareholder diversification requires rethinking the role of managerial incentive contracts is due to [Gordon \(1990\)](#). He shows in a reduced form principal-agent model without product market competition that a particular feature of managerial compensation, namely relative performance evaluation, should be less prevalent when firms benefit more from their competitors’ good performance. Similar theoretical arguments have since been discussed by [Macho-Stadler and Verdier \(1991\)](#), [Hansen and Lott \(1996\)](#), [Rubin \(2006\)](#), and [Kraus and Rubin \(2006\)](#).<sup>5</sup> In contrast, rather than focusing on a specific component of managerial compensation, our theoretical framework considers the totality of managerial incentives and explicitly considers their interplay with strategic product market behavior. Analogously, rather than focusing only on changes in salary, bonuses, or any other specific feature of managerial compensation, our empirical analysis of managerial incentives accounts for all links between firm performance and executive wealth, as suggested by [Edmans et al. \(2017\)](#).<sup>6</sup> Finally, our theoretical

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<sup>4</sup>The vast theoretical and empirical literature on managerial incentives is reviewed by [Murphy \(1999\)](#) and [Edmans and Gabaix \(2016\)](#).

<sup>5</sup>[Ha et al. \(2020\)](#) argue that firms design incentives to encourage collusion between product market competitors when local enforcement against collusion weakens. In contrast, our framework does not feature coordinated effects such as collusion, but instead just unilateral effects through common ownership.

<sup>6</sup>[Antón et al. \(2016\)](#) and [Liang \(2016\)](#) empirically document that a specific industry-level measure of common ownership, namely MHHID, is negatively related to the strength of managerial relative pay-for-performance sensitivity whereas [Kwon \(2016\)](#) offers contradictory evidence. The approach of these papers is problematic for two reasons. First, [Edmans et al. \(2017\)](#) argue that “any empirical measure of executive incentives must take into account the incentives provided by changes in the value of the executive’s equity holdings—i.e., measure wealth-

and empirical analysis exclusively focuses on explicit, pecuniary managerial incentives. However, implicit incentives resulting from the managerial labor market may be important as well ([Jenter and Kanaan, 2015](#)).

The remainder of the paper proceeds as follows. Section 2 outlines the setup of the theoretical framework, Section 3 derives its results, and Section 4 discusses how its predictions are useful in understanding empirical facts about common ownership. Section 5 describes the data used for the empirical analysis, as well as the various common ownership measures. Section 6 presents our empirical design and results. Section 7 concludes. Appendix A contains additional discussion of the theoretical framework, proofs, and model extensions. Appendix B contains additional empirical results.

## 2 Theoretical Framework

We embed optimal managerial incentive contracts and common ownership in a model of product market competition. Ownership is taken to be exogenous. Firms’ marginal costs, product prices, market shares, and profits are endogenously co-determined with the simple profit-based incentive contracts given to managers by (common) owners. Managers optimally respond to their incentive schedules by choosing effort, which improves firm-wide productivity. Managers do not have any knowledge of the ownership structures in the industry.<sup>7</sup>

### 2.1 Product Market Competition

Consider an industry with  $n$  firms, each producing a differentiated product. Each firm is owned by a majority owner and a set of minority owners. Aside from a literal interpretation, this assumption can also be understood as a metaphor for an explicit or implicit coalition of shareholders that jointly hold an effective majority of the stock being voted. Explicit coalitions

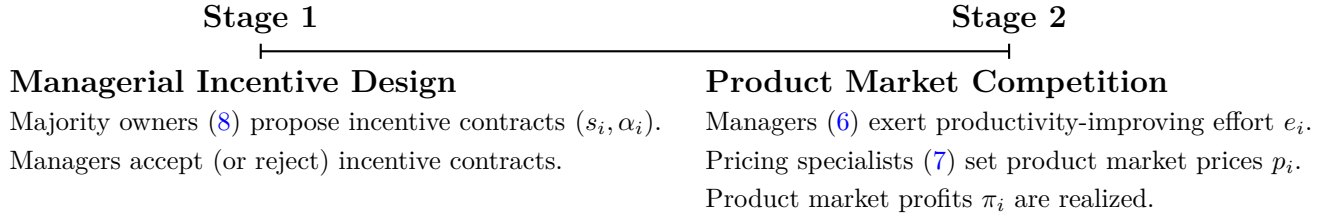
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performance sensitivities, rather than pay-performance sensitivities” and that “focusing only on changes in salary, bonuses, and new equity grants misses the majority of incentives.” Second, [Backus et al. \(2020a\)](#) and [Backus et al. \(2021\)](#) show theoretically and empirically that MHHID is a flawed industry-level measure of common ownership. Instead, they propose the use of firm-level profit weights (“kappas”) which we employ as our primary measure of common ownership.

<sup>7</sup>Our analysis does not consider additional agency conflicts between shareholders and boards, or between boards and compensation committees. We thus adopt an ubiquitous assumption in the literature studying how owners structure compensation contracts to incentivize managers to compete in the product market ([Hart, 1983](#); [Vickers, 1985](#); [Fershtman and Judd, 1987](#); [Skliwas, 1987](#); [Fumas, 1992](#); [Reitman, 1993](#); [Alexander and Zhou, 1995](#); [Schmidt, 1997](#); [Kedia, 1998](#); [Joh, 1999](#); [Spagnolo, 2000](#); [Raith, 2003](#)).

are discussed by [Shekita \(2020\)](#), as well as [Olson and Cook \(2017\)](#). [Moskalev \(2020\)](#) shows conditions under which shareholders with similar portfolios will optimally vote the same way, and therefore will be regarded as an implicit coalition or a single block by managers.

Each firm is run by a single (risk-averse) top manager.<sup>8</sup> The model has two stages. Stage 1 is a standard principal-agent setup in which the majority owner (she) of each firm proposes an incentive contract to the manager (he) of that firm, which the manager can accept or reject. In stage 2, each firm's top manager can improve firm productivity (i.e., marginal cost) through costly private effort that optimally responds to the managerial incentives designed in stage 1. This productivity improvement is not market-specific; it applies to the production costs of all the products the firm produces. In stage 2, the firms engage in differentiated Bertrand competition in which all of the firms' pricing specialists set product market prices to maximize firm profits, taking firm productivity determined by the top manager's effort choice as given.<sup>9</sup> As is customary, we assume that a manager's privately costly actions in stage 2 are non-contractible, but that firm profits are contractible. This allows managerial incentives to be contingent on firm performance. The model's timeline is summarized in Figure 1.



**Figure 1.** Model Timeline

Following [Singh and Vives \(1984\)](#) and [Häckner \(2000\)](#), we derive demand from the behavior of a representative consumer with the following quadratic utility function:

$$U(\vec{q}) = \omega \sum_{i=1}^n q_i - \frac{1}{2} \left( \rho \sum_{i=1}^n q_i^2 + 2\gamma \sum_{i \neq j} q_i q_j \right) \quad (1)$$

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<sup>8</sup>Managerial risk aversion is a common assumption in principal-agent models and interacts with the random firm profit assumption. However, it is not crucial to our model. As we discuss in Section [A.1.4](#), the same qualitative predictions would hold for a risk-neutral manager.

<sup>9</sup>For the sake of brevity our exposition focuses on differentiated Bertrand competition (i.e., strategic complements), but all of our results also hold for differentiated Cournot competition (i.e., strategic substitutes). See Section [A.1.1](#) for additional discussion.



where  $q_i$  is the quantity of product  $i$ ,  $\vec{q} = (q_1, \dots, q_n)$  is the vector of all quantities,  $\omega > 0$  represents overall product quality,  $\rho > 0$  measures the concavity of the utility function, and  $\gamma$  represents the degree of substitutability between the two differentiated products  $i$  and  $j$ .  $\rho > \gamma > 0$  ensures that the products are (imperfect) substitutes. The higher the value of  $\gamma$ , the more alike the products are. The resulting consumer maximization problem yields linear demand for each product  $i$ , such that the firms face symmetric demand functions in market  $l$ . This is given by

$$q_i(\vec{p}) = A - bp_i + a \sum_{j \neq i} p_j \quad (2)$$

where  $\vec{p} = (p_1, \dots, p_n)$  is the vector of all product market prices,  $A = \frac{\omega}{\rho + (n-1)\gamma}$ ,  $b = \frac{\rho + (n-2)\gamma}{[\rho + (n-1)\gamma](\rho - \gamma)}$ , and  $a = \frac{\gamma}{[\rho + (n-1)\gamma](\rho - \gamma)}$ . By assuming  $\rho > \gamma > 0$  we have  $b > (n-1)a > 0$ . Thus, a firm's price choice has a greater impact on the demand for its own product than its competitive rivals' actions in that particular market.

Each firm  $i$  has a marginal cost given by

$$c_i = \bar{c} - e_i \quad (3)$$

where  $\bar{c} < \omega$  is a constant and  $e_i$  is the effort exerted by firm  $i$ 's manager. By allowing managerial effort to improve firm productivity in this way, we follow similar model setups used in [Raith \(2003\)](#) as well as in canonical models of corporate (process) innovation under strategic competition ([D'Aspremont and Jacquemin, 1988](#); [Kamien et al., 1992](#)). Importantly, this specification means that the marginal benefit of managerial effort rises with firm size, as in [Baker and Hall \(2004\)](#), who also verify this assumption empirically. A model in which managers choose the level of managerial perks and owners aim to limit these perks (rather than to encourage the level of managerial effort) is isomorphic to our model, as we discuss in Section 4.1.<sup>10</sup>

The profits of firm  $i$  are then given by

$$\pi_i = [p_i - (\bar{c} - e_i)](A - bp_i + a \sum_{j \neq i} p_j) + \varepsilon_i \quad (4)$$

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<sup>10</sup>In our model which embeds managerial contracts in a setting of strategic competition, managerial incentives and the ensuing productivity improvements are influenced both by the common ownership concerns of shareholders and by the degree of product market competition. The latter effect is the principal focus in theoretical work by [Raith \(2003\)](#) and empirical analyses by [Cuñat and Guadalupe \(2005\)](#), [Cuñat and Guadalupe \(2009\)](#), and [Backus \(2020\)](#).

Importantly, an increase in the price  $p_j$  of firm  $j$  has a positive effect on the profit of firm  $i$ : firms benefit from softer competition by rivals, as in virtually all models of product market competition. We assume that  $\varepsilon_i$  is normally distributed with zero mean and variance  $\sigma^2$ , and is independent of the other firms' profit shocks.

## 2.2 Top Managers

All managers simultaneously choose productivity-improving effort levels in stage 2 in accordance with the incentives given by their contracts. The manager of firm  $i$  who has an outside option equal to  $\bar{u}$  is offered the following total compensation in the form of a linear contract:

$$w_i = s_i + \alpha_i \pi_i \quad (5)$$

where  $s_i$  is a fixed salary and  $\alpha_i$  is the incentive slope on firm  $i$ 's profits  $\pi_i$ . This compensation contract mirrors real-world compensation practices, as top managers' compensation is usually tied to their firm's equity value, which reflects the discounted value of firm profits.<sup>11</sup> The manager's base salary  $s_i$  is used to satisfy the individual rationality constraint, which is pinned down by the manager's outside option  $\bar{u}$ . Each manager's utility  $u_i$  is given by  $-\exp[-r(w_i - \frac{1}{2}q_i e_i^2)]$ , where  $r$  is the agent's degree of (constant absolute) risk aversion and  $\frac{1}{2}q_i e_i^2$  is his disutility of exerting effort.

The functional form of our cost-of-effort function implies that cutting marginal costs is relatively harder for the manager when the firm is large. This ensures that for a given incentive slope  $\alpha_i$  the manager's incentive to exert effort does not vary with the firm's output  $q_i$  because both the manager's marginal impact on the firm's profit (through the marginal cost  $c_i$ ) and the manager's marginal effort cost grow as the size of the firm grows. In other words, for a given incentive slope  $\alpha_i$  the manager's effort is size-invariant. However, our results also hold for more general cost-of-effort functions of the form  $(\xi + \tau q_i)\frac{1}{2}e_i^2$ , where  $\xi$  and  $\tau$  are non-negative constants.<sup>12</sup>

The manager's wage has an expected value of  $E[w_i] = s_i + \alpha_i \pi_i$  and a variance of  $\text{Var}[w_i] = \alpha_i^2 \sigma^2$ .

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<sup>11</sup>Our analysis would be simpler if we assumed, as in [Raith \(2003\)](#), that managers are directly rewarded for marginal cost reduction rather than firm profit. However, such an assumption would break the close match between our theoretical analysis and empirical implementation.

<sup>12</sup>For example,  $\tau = 0$  yields the familiar quadratic cost-of-effort function used in many other principal-agent models. Because of the interdependency between managerial incentives and product market competition in our model, for a given  $\alpha_i$  this assumption leads to greater managerial effort as the firm's output grows.

Given the normal distribution of  $\varepsilon_i$ , maximizing utility is therefore equivalent to maximizing the certainty equivalent

$$CE_i = s_i + \alpha_i \pi_i - \frac{r}{2} \alpha_i^2 \sigma^2 - \frac{1}{2} q_i e_i^2.$$

Thus, each manager  $i$  chooses effort  $e_i$  to maximize his expected compensation, net of risk and effort costs:

$$\max_{e_i} CE_i = s_i + \alpha_i [p_i - (\bar{c} - e_i)] (A - bp_i + a \sum_{j \neq i} p_j) - \frac{r}{2} \alpha_i^2 \sigma^2 - \frac{1}{2} (A - bp_i + a \sum_{j \neq i} p_j) e_i^2. \quad (6)$$

Crucially, our model assumes that the manager only makes high-level decisions that influence firm-wide productivity, but that he does not control more detailed low-level decisions such as product market pricing. Product market prices are instead set by pricing specialists, who we introduce in the next subsection.

## 2.3 Pricing Specialists

All pricing specialists choose the optimal price level in stage 2 to maximize firm profits taking firm productivity (i.e., marginal cost), which is simultaneously determined by the top manager's effort choice, as given. The optimal pricing decision is given by

$$\max_{p_i} \pi_i = [p_i - (\bar{c} - e_i)] (A - bp_i + a \sum_{j \neq i} p_j) + \varepsilon_i. \quad (7)$$

As is customary, we assume that this pricing decision does not involve any privately borne costs. Therefore, each pricing specialist's interests perfectly coincide with the classical objective of individual firm profit maximization.<sup>13</sup> Importantly, the pricing specialists in our model choose prices without taking common ownership motives into account—they simply choose prices to maximize individual firm profit.

Our model is robust to changes in timing as we explain in Section A.1.2. For example, we obtain the same results if pricing specialists set prices in stage 3 after observing the firm's marginal cost  $c_i$  or the effort choice  $e_i$  of the manager of their firm rather than setting prices concurrently with

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<sup>13</sup>This pricing decision could also be made by the manager himself, who already receives a share  $\alpha_i$  of the firm profit to motivate his effort choice, or by anybody else whose sole intention is to maximize firm profit.

the effort choices of top managers in stage 2.

## 2.4 Owners

There are  $n$  owners. Each owner  $i$  owns a (majority) stake in firm  $i$  as well as shares in other firms  $j \neq i$ . [Azar \(2012\)](#), [López and Vives \(2018\)](#), and [Backus et al. \(2020a\)](#) show that owner  $i$ 's maximization problem can be restated in the following way:

$$\phi_i = \pi_i - w_i + \sum_{j \neq i} \kappa_{ij} (\pi_j - w_j) \quad (8)$$

where  $\kappa_{ij}$  is the weight that owner  $i$  places on the net profits  $(\pi_j - w_j)$  of each competitor  $j$ . Its exact value depends on the type of ownership and corresponds to what [Edgeworth \(1881\)](#) termed the “coefficient of effective sympathy among firms.” In fact, there is a long tradition in economics of weighting shareholder interests in the objective function of the firm, including [Drèze \(1974\)](#), [Grossman and Hart \(1979\)](#), and [Rotemberg \(1984\)](#). We assume that the profit weight  $\kappa$  is between 0 (separate ownership) and 1 (perfectly common ownership).<sup>14</sup> By maximizing equation (8), the owner essentially maximizes a weighted average of her own firm as well as other firms' profits.<sup>15</sup>

In stage 1, each majority owner  $i$  publicly proposes an incentive contract  $(s_i, \alpha_i)$  for her manager  $i$ , such that the product market behavior in stage 2, as induced by the incentive contract designed in stage 1, maximizes her profit shares in all the firms. The optimal incentive contract for manager  $i$  therefore internalizes the effect on profits of other firms in the industry, to the extent that the majority owner of firm  $i$  also owns cash flow rights of (but does not have influence or control over) those other firms.

The assumption that the majority owner sets the terms of the incentive contract is made

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<sup>14</sup>We use the  $\kappa$  notation of [Backus et al. \(2020a\)](#) which is equivalent to  $\lambda$  in [Azar \(2012\)](#) and [López and Vives \(2018\)](#). Values of  $\kappa$  exceeding 1 are possible, but they lead to owners placing more weight on their competitors' profits than on their own profits. This would make it possible for common ownership to create incentives for the “tunneling” of profits from one firm to another ([Johnson et al., 2000](#)).

<sup>15</sup>The particular objective function given in equation (8) is a normalization. Firms do not maximize a sum that is larger than the entire economy. In particular, [López and Vives \(2018\)](#) consider two types of minority shareholdings: when investors acquire firms' shares (*common ownership*) with silent financial interest or proportional control, and when firms acquire other firms' shares (*cross-ownership*). In both cases, they show that when the stakes are symmetric, firm/owner  $i$ 's problem is to maximize the objective function given in equation (8). This formulation also allows us to abstract away from other governance problems arising from diversified or dispersed owners ([Admati et al., 1994](#)) or the absence of block owners: holding stakes in other firms does not diminish an owner's incentive to increase the value of firm  $i$ .

Number	Equation	Description
(1)	$U(\vec{q}) = \omega \sum_{i=1}^n q_i - \frac{1}{2} \left( \rho \sum_{i=1}^n q_i^2 + 2\gamma \sum_{i \neq j} q_i q_j \right)$	Representative Consumer
(2)	$q_i = A - bp_i + a \sum_{j \neq i} p_j$	Demand for Product of Firm $i$
(3)	$c_i = \bar{c} - e_i$	Productivity Improvement
(4)	$\pi_i = [p_i - (\bar{c} - e_i)]q_i + \varepsilon_i$	Firm Profits
(5)	$w_i = s_i + \alpha_i \pi_i$	Managerial Compensation
(6)	$\max_{e_i} CE_i = s_i + \alpha_i [p_i - (\bar{c} - e_i)]q_i - \frac{r}{2} \alpha_i^2 \sigma^2 - \frac{1}{2} q_i e_i^2$	Managerial Utility
(7)	$\max_{p_i} \pi_i = [p_i - (\bar{c} - e_i)](A - bp_i + a \sum_{j \neq i} p_j) + \varepsilon_i$	Pricing Specialist
(8)	$\max_{s_i, \alpha_i} \phi_i = \pi_i - w_i + \sum_{j \neq i} \kappa_{ij} (\pi_j - w_j)$	Owner Objective Function

**Table 1.** Summary of the Model Setup

for expositional simplicity. Shareholder voting models in [Azar \(2012\)](#) and [Azar \(2016\)](#) provide theoretical justifications for this assumption. However, even with “one share, one vote” majority voting, the majority owner would be able to implement the same contract. In settings without a majority owner, the largest investor usually has the greatest chance of being pivotal. Our empirical measure of common ownership accounts for this situation. Finally, in [Section 4.1](#) we show that large owners may choose to remain passive instead of engaging in corporate governance and designing managerial incentive contracts.

We follow the literature on managerial incentives for product market competition ([Vickers, 1985](#); [Fershtman and Judd, 1987](#); [Sklivas, 1987](#); [Fershtman et al., 1991](#)) by assuming public observability of incentive contracts. Indeed, information on the level and structure of managerial incentive contracts is publicly available. However, as we explain in [Section A.1.2](#) this assumption that the contract between an owner and the top manager of her firm is observable to managers and pricing specialists at other firms is not central to our analysis. All of our results also hold for privately observable managerial incentive contracts.

The maximization problem for the majority owner of each firm  $i$  in stage 1 is subject to the IR and IC constraints of the manager of firm  $i$  and the managerial efforts and prices at all firms constituting a Nash equilibrium given each owner  $i$ ’s choice of  $s_i$  and  $\alpha_i$ . That is, her maximization

problem is given by:

$$\begin{aligned} \max_{s_i, \alpha_i} \phi_i &= (\pi_i - s_i - \alpha_i \pi_i) + \sum_{j \neq i} \kappa_{ij} (\pi_j - s_j - \alpha_j \pi_j) \\ \text{s.t. } u_i &\geq \bar{u} \quad \text{and} \quad e_i^* \in \arg \max_{e_i} \mathbb{E}[-\exp(-r(s_i + \alpha_i \pi_i - q_i e_i^2/2))] \quad \text{and} \quad p_i^* \in \arg \max_{p_i} \pi_i. \end{aligned} \tag{9}$$

To ensure that each owner's problem has an interior solution, we assume that  $r\sigma^2$  is sufficiently large. Finally, it is important to remind the reader that in our model, each manager and each pricing specialist is solely rewarded for the profits  $\pi_i$  of his own firm. This means that a common owner who cares about the portfolio objective  $\phi_i$  rather than about individual firm profits  $\pi_i$ , as the manager and the pricing specialist do, can only influence competitive behavior by varying the manager's incentive slope  $\alpha_i$ . Table 1 provides a summary of the model setup.

### 3 Theoretical Analysis

We begin our analysis of the theoretical framework by investigating the effect of common ownership on managerial incentives in a single-market industry with symmetric firms. We then consider an extension with firm-level differences in ownership and multiple markets to illustrate the differential effects of common ownership on managerial incentives, costs, prices, quantities, and product market structure.

#### 3.1 Baseline Model with Symmetric Owners and Single-Product Firms

To simplify the exposition, in our baseline model we assume that the owners are symmetric such that owner  $i$  owns a majority stake in firm  $i$  as well as a residual symmetric share in all other firms. Therefore, we have  $\kappa_{ij} = \kappa$ .

In stage 2 of the game, the managers simultaneously choose effort and pricing specialists choose prices given the set of incentive contracts. For a given contract  $(s_i, \alpha_i)$ , manager  $i$ 's first-order condition with respect to productivity-improving effort  $e_i$ , along with the pricing specialist's first-order condition with respect to price  $p_i$ , can be rearranged to yield the following best-response

functions:

$$e_i = \alpha_i \tag{10}$$

$$p_i = \frac{A + b(\bar{c} - e_i) + a \sum_{j \neq i} p_j}{2b}. \tag{11}$$

First, note that the stronger the incentives  $\alpha_i$  given to the manager, the larger the efficiency improvements  $e_i$  he will undertake, as can be seen by the effect of  $\alpha_i$  in equation (10). This is because a larger share of the firm's profits rewards the manager for his costly private effort to improve efficiency and profits. Indeed, this result illustrates that  $\alpha$ , in addition to representing an explicit incentive slope, can also serve as a reduced-form mechanism for any governance intervention that has the effect of inducing efficiency improvements in the firm. In line with this interpretation and with our model assumptions, [Giroud and Mueller \(2011\)](#) document that weak governance firms, particularly those in less competitive industries, have lower labor productivity and higher input costs.

Second, stronger managerial incentives also lead to lower prices because the efficiency improvements induced by stronger incentives increase the firm's per-unit profit margin, thereby encouraging the manager to produce a higher quantity and set a lower price. This is apparent by looking at the effect of  $e_i$  in equation (11). Stronger managerial incentives lead to more competitive product market behavior in the form of lower prices (and higher output). This feature also means that in our model managerial productivity has a multiplicative effect on firm profits (as in [Gabaix and Landier \(2008\)](#)) because it improves the firm's profit margin and increases the size of the firm. Third, the base salary  $s_i$  does not affect the managers' decisions.

The first-order conditions (10) and (11) yield a system of  $2n$  linear equations which we solve for the equilibrium efforts  $e_i^*(\vec{\alpha})$ , equilibrium prices  $p_i^*(\vec{\alpha})$ , and equilibrium profits  $\pi_i^*(\vec{\alpha})$  of the  $n$  firms as a function of the vector of incentive slopes  $\vec{\alpha} = (\alpha_1, \dots, \alpha_n)$ . As we will show, these incentive slopes in turn depend on the level of common ownership  $\kappa$ .

Recall that the objective function of the majority owner of firm  $i$ , given in equation (8), captures the profit shares in her primary firm  $i$  and all other firms  $j \neq i$ . In stage 1, each majority owner has two instruments at her disposal. First, she uses the salary  $s_i$  to satisfy the manager's individual rationality constraint. Second, taking into account the effects of the incentive slope  $\alpha_i$  on the stage 2 equilibrium efforts and prices, she uses the incentive slope  $\alpha_i$  to maximize her objective

function  $\phi_i$ . The derivative of the owner's objective function with respect to  $\alpha_i$  is given by

$$\frac{\partial \phi_i}{\partial \alpha_i} = \frac{\partial \pi_i^*}{\partial \alpha_i} - r\sigma^2 \alpha_i^2 - q_i^* \alpha_i - \frac{\alpha_i^2}{2} \frac{\partial q_i^*}{\partial \alpha_i} + \kappa \sum_{j \neq i} \left( \frac{\partial \pi_j^*}{\partial \alpha_i} - \frac{\alpha_j^2}{2} \frac{\partial q_j^*}{\partial \alpha_i} \right).$$

The last term that includes  $\kappa$  captures the impact of changing  $\alpha_i$  on the net profits of all the firms other than the investor's primary firm  $i$ . Because stronger incentives for the manager of firm  $i$  hurt the profits of all other firms  $j \neq i$ , and because the majority owner of firm  $i$  cares about these profits with intensity  $\kappa$ , this leads to our central theoretical result.

**Proposition 1.** *If firms interact in the product market ( $a > 0$ ), the symmetric equilibrium incentives  $\alpha_i = \alpha^*$  given to managers decrease and the firms' marginal costs  $c_i$  increase with the degree of common ownership  $\kappa$ .*

As common ownership measured by  $\kappa$  increases, the (majority) owner of firm  $i$  cares relatively more about the net profits of firm  $j$  in the industry (see equation (8)). Thus, each owner now prefers competition to be softer between the firms that she partially owns. In other words, each owner  $i$  would now like to induce a higher price  $p_i$  because that benefits the profits  $\pi_j$  of firm  $j$ . While the majority owner of firm  $i$  does not directly control the product market price  $p_i$ , she can induce less aggressive product market behavior (and thus a higher price  $p_i$ ) by setting a lower incentive slope  $\alpha_i$  in stage 1. As can be seen from the best-response functions (10) and (11), this leads to less cost-cutting effort  $e_i$  by the manager (and hence higher marginal cost  $c_i$ ) and a higher price  $p_i$  set by the pricing specialist in stage 2. This, in turn, benefits the net profits of firm  $j$  which become a relatively more important part of owner  $i$ 's portfolio profits  $\phi_i$  as common ownership  $\kappa$  increases.

In our model, common ownership has anticompetitive effects in the sense of higher prices.<sup>16</sup> However, these higher prices are *not* caused by higher markups. Instead they are the result of a “productive inefficiency” or “cost inefficiency” (in the sense of higher marginal cost  $c_i$  than in the absence of common ownership) caused by reduced managerial incentives and the resulting under-investment in productivity improvements. The principal-agent problem is the fundamental source of this productive inefficiency. If a common owner could directly control pricing she would instead use higher markups and leave managerial incentives at the same high level as under no common

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<sup>16</sup>Thus, our model also proves a theoretical conjecture by [Admati et al. \(1994\)](#) that “firms that act in the interests of diversified shareholders might well refrain from competing against each other in the product market.”



ownership. But without direct control of prices a common owner can only underincentivize the manager which in turn raises costs and thereby increases prices while leaving price-cost markups essentially unchanged.

Indeed, as in our model, [Aslan \(2019\)](#) finds that in the context of the consumer goods industry the positive relationship between common ownership and prices is channeled largely through marginal cost variation while markups are unaffected by common ownership. Yet, even despite this productive inefficiency, in equilibrium not only are portfolio profits  $\phi_i$  higher, but net profits  $\pi_i - w_i$  are also higher when common ownership is higher, in line with the findings of [Boller and Scott Morton \(2020\)](#). In our model this occurs because the lower managerial incentives reduce business stealing between all the firms in the industry and economize on the productivity investment costs for which the managers have to be compensated.

**Corollary 1.** *Firm net profits  $\pi_i - w_i$  increase with the degree of common ownership  $\kappa$ .*

By forgoing the provision of high-powered incentive contracts, common owners are “excessively deferential” toward managers ([Bebchuk et al., 2017](#); [Bebchuk and Hirst, 2019](#))—relative to undiversified owners (and relative to the corporate finance benchmark level of intervention, premised on the assumption that firms do not interact strategically in the product market)—but that outcome is optimal from the perspective of the common owner. Because managers of more commonly-owned firms have less performance-sensitive incentives they also exert lower effort, resulting in lower firm productivity. This is in line with the interpretation that managers of these firms with endogenously weak corporate governance are allowed to “enjoy the quiet life” ([Bertrand and Mullainathan, 2003](#)) at the expense of firm productivity.

As we discuss in detail in Section 4, the model does not imply that common owners directly design managerial incentive contracts to maximize  $\phi_i$ . Common owners are simply more willing to tolerate managerial slack and the resulting productive inefficiency at their portfolio firms because doing so also leads to less intense competition for the other firms in which they hold shares. The model provides an “as-if” explanation for the empirical phenomenon that common owners are less engaged in managerial incentive design than undiversified activists.

Proposition 1 also emphasizes the role of strategic product market competition between firms. If the firms operated in separate markets (i.e.,  $a = 0$ ) and thus each firm’s pricing decisions had no impact on the demand and profits of the other firm, the degree of common ownership  $\kappa$  between the firms would not have any impact on the equilibrium managerial incentives  $\alpha^*$ . More generally,

in any setting (e.g., perfect competition) where a firm can treat its own product market behavior as having no impact on the behavior and profits of other firms, common ownership  $\kappa$  will not influence managerial incentives  $\alpha^*$ .<sup>17</sup> This insight further highlights that the driving force of our model is not diversification in general, but rather diversification *within* the same industry.

### 3.2 Multimarket Firm-level Variation in Common Ownership

The baseline model considers effects of common ownership in a single-market industry with symmetric firms, but it ignores how changes in firm-level common ownership can differentially affect firms' product market strategies across multiple markets. First, we show that firm-level variation in common ownership (i.e., asymmetric  $\kappa_{ij}$  rather than symmetric  $\kappa$  as in our baseline model) can lead to firm-level variation in managerial incentives. Second, we demonstrate that it can also generate firm- and market-level variation in prices, quantities, and concentration, as well as cross-market variation in competitive behavior, even within the same firm.

Consider an industry with three (geographically) separate markets ( $l = \text{I, II, III}$ ) and three firms ( $i = 1, 2, 3$ ) owned by three investors. Each firm produces a differentiated product in two of the three markets such that there are two firms' products offered in each market. Specifically, firm 1 produces in markets I and II, firm 2 produces in markets II and III, and firm 3 produces in markets III and I. There are three investors such that each firm is controlled by one majority owner and two minority owners hold the remaining cash flow rights. As a result, owner  $i$ 's objective function is given by

$$\phi_i = \pi_i - w_i + \kappa_{ij}(\pi_j - w_j) + \kappa_{ik}(\pi_k - w_k).$$

Although our analysis focuses on the case with three firms, three markets, and three investors, the results we present in this section straightforwardly generalize to any number of  $n$  firms which are owned by  $n$  investors and which each produce  $n - 1$  products across  $n$  distinct markets.

As before, each firm is run by a single top manager who only optimally responds to a linear profit-based incentive contract  $w_i = s_i + \alpha_i \pi_i$ , where the total firm profit  $\pi_i$  is the sum of the profits of all the submarkets  $\pi_i = \sum_l \pi_{i,l}$ . The manager's incentive contract only rewards firm-wide performance and attaches equal weights to the submarket profits  $\pi_{i,l}$  in which firm  $i$  operates.

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<sup>17</sup>In Section A.1.5, we discuss additional insights of our theoretical framework that result from comparative statics of the degree of product differentiation  $a$ .

In stage 1, majority owners set incentive contracts. In stage 2, top managers choose effort levels to maximize the expected utility given their incentive contract, and pricing specialists choose prices to maximize market-level (or firm) profits. As before, both managers and pricing specialists take their respective actions without taking common ownership motives (given by  $\kappa_{ij}$ ) into account. Each manager simply chooses effort  $e_i$  to maximize his own utility  $u_i$  and pricing specialists choose prices to maximize individual firm market profit  $\pi_{i,l}$ , neither of which feature  $\kappa_{ij}$ .

The firms face symmetric demand functions in market  $l$  given by

$$q_{i,l}(p_{i,l}, p_{j,l}) = A - bp_{i,l} + ap_{j,l}.$$

Each firm  $i$  has a constant marginal cost given by  $c_i = \bar{c} - e_i$ . The efficiency improvement resulting from managerial effort  $e_i$  is not market-specific but applies to the production costs of all the products the firm produces (i.e.,  $e_{i,l}$  is constrained to be equal to  $e_i$  for all markets  $l$ ). This captures the idea that top managers make high-level decisions that affect the entire firm. However, all of our results would also obtain if we allowed for product market-specific investments  $e_{i,l}$ . The combined profits of firm 1 which sets prices  $p_{1,I}$  for market I and  $p_{1,II}$  for market II, are given by

$$\pi_1 = (p_{1,I} - c_1)(A - bp_{1,I} + ap_{3,I}) + (p_{1,II} - c_1)(A - bp_{1,II} + ap_{2,II}) + \varepsilon_i.$$

Each manager  $i$  chooses effort  $e_i$  to maximize his expected compensation, net of risk and effort costs:

$$\max_{e_i} s_i + \alpha_i \pi_i - \frac{r}{2} \alpha_i^2 \sigma^2 - \frac{1}{2} q_i e_i^2$$

where  $q_i = \sum_l q_{i,l}$  is the firm's total output in both markets in which it operates. The pricing specialist of firm  $i$  for market  $l$  sets  $p_{i,l}$  to maximize market-level profit  $\pi_{i,l}$  of firm  $i$  in market  $l$

$$\max_{p_{i,l}} (p_{i,l} - c_i)(A - bp_{i,l} + ap_{j,l}).$$

For firm 1, this results in the following familiar best-response functions:

$$\begin{aligned} e_1 &= \alpha_1 \\ p_{1,I} &= \frac{A + b(\bar{c} - e_i) + ap_{3,I}}{2b} \\ p_{1,II} &= \frac{A + b(\bar{c} - e_i) + ap_{2,II}}{2b} \end{aligned}$$

which feature the same positive and negative relationships, respectively, between managerial incentives for effort and prices as in our baseline model.

The majority owner of firm  $i$  solves:

$$\begin{aligned} \max_{s_i, \alpha_i} \phi_i &= \pi_i - s_i - \alpha_i \pi_i + \kappa_{ij}(\pi_j - s_j + \alpha_j \pi_j) + \kappa_{ik}(\pi_k - s_k + \alpha_k \pi_k) \\ \text{s.t. } u_i &\geq \bar{u} \quad \text{and} \quad e_i^* \in \arg \max_{e_i} \mathbb{E}[-\exp(-r(s_i + \alpha_i \pi_i - q_i e_i^2/2))] \quad \text{and} \quad p_{i,l}^* \in \arg \max_{p_{i,l}} \pi_{i,l} \end{aligned}$$

where  $\kappa_{i,j}$  and  $\kappa_{i,k}$  capture the impact of the minority ownership shares that the majority owner of firm  $i$  holds in firms  $j$  and  $k$ .

We assume that there is one undiversified “maverick” owner who owns 100% of firm 1 (which we call the “maverick” firm) while the remaining two owners of firms 2 and 3 each own  $\delta$  of their majority firm and hold a minority stake of  $1 - \delta$  in the other firm, where  $1/2 \leq \delta < 1$ . This results in the following set of common ownership coefficients:  $\kappa_{1,2} = \kappa_{1,3} = \kappa_{2,1} = \kappa_{3,1} = 0$  and  $\kappa_{2,3} = \kappa_{3,2} = (1 - \delta)/\delta \equiv \kappa$ . In the markets I and II, the maverick firm is present. Thus, there is no overlap in ownership between the market competitors. In contrast, in the common ownership market III there is common ownership between the two firms, with its impact increasing in  $\kappa$  which is monotonically related to  $\delta$ . Figure 2 summarizes the model setup.

Before we derive the implications of these assumptions, we provide a real-world example that illustrates the importance of recognizing asymmetries in common ownership in multimarket settings. Consider the U.S. airline market, which has different geographic markets and routes and substantial firm-level variation in common ownership. Prior to its merger with and subsequent integration into Alaska Airlines in 2017, Virgin America had a radically different ownership structure compared to other large publicly listed U.S. airlines such as Delta, American, United, and JetBlue. Table 2 Panel A shows that Virgin America was predominantly owned by two of its founders: the entrepreneur Richard Branson, who held the largest share ownership of 30.77% (as well as another



**Figure 2.** Model Setup and Equilibrium Incentives and Prices for Multimarket Firm-level Variation in Common Ownership: Firm 1 is the “maverick” firm whereas firms 2 and 3 are the commonly-owned firms where  $50\% \leq \delta < 100\%$  and  $\kappa \equiv (1 - \delta)/\delta$ . In equilibrium,  $\alpha_1^* > \alpha_2^* = \alpha_3^*$  (Proposition 2) and  $p_H^* > p_M^* > p_L^*$  (Corollary 2).

15.34% through Virgin Group Holdings Limited), and the activist private equity group Cyrus Capital Partners (headed by Stephen Freidheim), which held 23.52%. Neither of these two owners held large stakes in industry competitors. In contrast, Table 2 Panel B shows that almost all other U.S. airlines had the same overlapping owners as their largest shareholders.<sup>18</sup> Given these stark differences in ownership arrangements, it is perhaps not too surprising that Virgin America won an unprecedented nine straight awards for “Top Domestic Airline” from Travel+Leisure because of its high quality and aggressive pricing. Airline industry experts described it as “the epitome of a market disruptor” (Taggart, 2016).<sup>19</sup>

[Insert TABLE 2 Here.]

<sup>18</sup>Backus et al. (2020a) show that the significant common ownership in the airline industry is by no means an exception, but that common ownership by large asset management companies is, in fact, the rule.

<sup>19</sup>One interesting exception in Panel B is the ultra-low cost airline Allegiant, in which the CEO held the largest ownership stake (20.30%). Tellingly, Allegiant has also been called an “industry disruptor” and a “maverick” by industry experts.

### 3.2.1 Managerial Incentives

Under such common ownership with a maverick owner, the objective functions of the owners of firms 2 and 3 are identical, in that they maximize the weighted sum of profits of those two firms, while the maverick owner of firm 1 solely maximizes the profits of firm 1. The resulting equilibrium incentive slopes are  $\alpha_1^*$  and  $\alpha_2^* = \alpha_3^*$  and the equilibrium prices are  $p_L^* \equiv p_{1,I}^* = p_{1,II}^*$  for the prices set by the maverick firm 1 in markets I and II,  $p_M^* \equiv p_{2,II}^* = p_{3,I}^*$  for the prices set by the commonly-owned firms 2 and 3 in markets I and II where these firms compete against the maverick firm 1, and finally  $p_H^* \equiv p_{2,III}^* = p_{3,III}^*$  for the prices set by the commonly-owned firms 2 and 3 in market III where these firms compete with each other.

**Proposition 2.** *The equilibrium incentives  $\alpha_2^* = \alpha_3^*$  given to managers of the commonly-owned firms 2 and 3 are strictly lower than those given to the manager of the maverick firm 1,  $\alpha_1^*$ . Therefore,  $c_2 = c_3 > c_1$ . The difference in both the managerial incentive slopes and the costs increases with the degree of common ownership  $\kappa$  between the commonly-owned firms 2 and 3.*

As before, the fact that the stage 2 equilibrium profit  $\pi_{j,l}^*(\alpha_i, \alpha_j)$  of firm  $j$  in market  $l$  is decreasing in  $\alpha_i$  immediately establishes the proposition. The intuition is also exactly the same as in our baseline model. Whereas the undiversified maverick owner only cares about the profits of firm 1, the two common owners of firms 2 and 3 also care about the impact of their respective managers' decisions on the other firm they own and with which they interact in market III. As a result, to induce less aggressive pricing choices (and thus less business stealing), these common owners set lower managerial incentive contracts than the maverick owner does. When the degree of common ownership  $\kappa$  increases, the common owners of firms 2 and 3 care more about the impact of their choice of  $\alpha_2$  and  $\alpha_3$  on the profit of the other commonly-owned firm and thus reduce these incentive slopes by a greater amount. In our analysis in Section 6, we investigate whether the empirical evidence is consistent with this link between managerial incentives and common ownership.

### 3.2.2 Product Market Effects

Beyond establishing a negative relationship between the strength of managerial incentives and common ownership, we can also analyze the impact that our proposed mechanism has on product market outcomes, including prices, quantities, and market structure. We show that even when

managers only undertake firm-wide (not market-specific) productivity improvements in response to the managerial incentive contracts given to them and have no knowledge of the underlying ownership structures of their firm, firm-level variation in managerial incentives can generate market-level variation in competitive outcomes within the same industry. This is in accordance with prior empirical findings in the common ownership literature. We begin by studying the effect on product market prices.

**Corollary 2.** *The equilibrium price  $p_{2,\text{III}}^* = p_{3,\text{III}}^* = p_H^*$  set by the two commonly-owned firms 2 and 3 in market III is higher than the price  $p_{2,\text{I}}^* = p_{3,\text{II}}^* = p_M^*$  set by the commonly-owned firms 2 and 3 in the maverick markets I and II, which in turn is higher than the price  $p_{1,\text{I}}^* = p_{1,\text{II}}^* = p_L^*$  set by the maverick firm in the maverick markets I and II. The difference in prices between the common ownership market III and the maverick markets I and II is increasing in the degree of common ownership  $\kappa$ .*

This corollary is a direct result of the differential effort choices induced by the difference in incentive contracts. Because the manager of the maverick firm 1 faces more high-powered incentives, he exerts greater effort which leads to lower marginal costs  $c_1$  than those of the commonly-owned firms 2 and 3,  $c_2 = c_3$ . As a result, the maverick firm is endogenously a low-cost firm, and the price  $p_L^*$  set by the maverick firm in markets I and II is always lower than those of the commonly-owned firms. This is true both in markets I and II, where they face the low-cost maverick firm and they therefore set  $p_M^*$ , as well as in market III where these high-cost firms face each other and therefore set  $p_H^*$ . Hence,  $p_H^* > p_M^* > p_L^*$ . Finally, because the difference in effort incentives increases with the degree of common ownership  $\kappa$ , so does the difference in prices between the common-ownership market III and the maverick markets I and II.

Because in our model common owners cannot directly set higher prices, but can only indirectly raise prices by lowering managerial incentives and increasing costs, common ownership does not have a direct impact on price-cost markups  $\frac{p_{i,l}}{c_i}$ . As a result, the effect of common ownership on markups is very small, ambiguous, and mostly driven by cost passthrough. For example, with our linear demand specification the commonly-owned firms have a lower average markup across firms than the maverick firm, but they charge higher markups in the common ownership market than in the maverick market. Furthermore, under differentiated Bertrand oligopoly depending on the curvature of demand and the form of strategic interaction cost passthrough can be less or more than 100 percent (Anderson et al., 2001) and thus markups could either decrease or

increase following a common ownership-induced change in costs. In line with our prediction, in the reduced-form empirical studies of [Aslan \(2019\)](#) and [Koch et al. \(2020\)](#) price-cost markups are not consistently positively correlated with measures of common ownership. Similarly, the structural analysis of [Backus et al. \(2021\)](#) in which the profit weights  $\kappa_{ij}$  are not included in the marginal cost specification but influence price setting, also rejects that common ownership has large or even modest effects on markups. However, our model emphasizes the point that even when common ownership has no impact on markups, it can still have an anticompetitive effect on prices simply through higher marginal costs resulting from common ownership-induced productive inefficiency.

Corollary 2 provides an explanation for the positive empirical relationship between market-level common ownership and prices, which has been documented for airlines using both reduced-form methods ([Azar et al., 2018](#)) and structural analysis [Park and Seo \(2019\)](#),<sup>20</sup> as well as for banking ([Azar et al., 2019](#)), agricultural seeds ([Torshizi and Clapp, 2019](#)), and consumer goods ([Aslan, 2019](#)). [Ruiz-Pérez \(2019\)](#) also provides evidence consistent with a positive relationship between common ownership and prices in airlines, but shows that it comes mostly from the effect of common ownership on entry decisions and their effect on the ensuing market structure. Recall that our theoretical framework assumes that owners (who care about their profit shares in other firms, as in equation (8)) can only influence the managers' productivity improvements, but that market specialists set prices solely to maximize their own firms' profits (see equation (7)). Indeed, [Ruiz-Pérez \(2019\)](#) finds that a hybrid model in which airlines act exactly according to the common owner profit shares for entry decisions, but choose prices to maximize just their own firms' profits, fits the data the best.

The high prices charged in market III are not the result of directly anticompetitive or even explicitly collusive behavior by the two commonly-owned firms operating in this market. Rather, they are merely the result of less productive firms (due to weakly-incentivized top managers) competing against each other in the same market. This indirect channel is entirely distinct from theories in which common owners directly intervene in firm strategy and pricing. Although effects of common ownership may also operate through more direct channels, our theoretical model

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<sup>20</sup>[Park and Seo \(2019\)](#) disprove [Kennedy et al.'s \(2017\)](#) claim that [Azar et al.'s \(2018\)](#) finding of a positive effect of common ownership on prices is due to the use of a reduced-form model. [Park and Seo \(2019\)](#) structurally estimate a large positive effect of common ownership on prices using a larger sample, as well as a more standard estimation procedure ([Berry et al., 1995](#); [Berry and Jia, 2010](#)).



illustrates that anticompetitive product market effects can exist without the use of such direct channels.

Another straightforward corollary of Proposition 2 is that the quantities produced by the firms, product market concentration, and common ownership are endogenously related. Whereas in the common-ownership market the firms charge equal prices ( $p_H^*$ ) and have equal market shares, the maverick firm charges lower prices ( $p_L^*$ ) than the commonly-owned firms in the maverick markets ( $p_M^*$ ). As a result, the produced quantities correlate negatively with common ownership, as documented by Azar et al. (2018) for the U.S. airline industry. Moreover, in the maverick markets the maverick has a larger market share than the commonly-owned firm, whereas in the common ownership market, the market shares are symmetric. This leads to greater market concentration than in the common ownership market. As a result, market concentration is negatively correlated with common ownership at the market level. This prediction corresponds to an empirical fact documented in the airline (Azar et al., 2018) and the banking industry (Azar et al., 2019), but which until now does not have a theoretical explanation.

**Corollary 3.** *The equilibrium output and product market concentration in the common-ownership market is lower than in the maverick markets,  $Q^{III} < Q^I = Q^{II}$  and  $HHI^{III} < HHI^I = HHI^{II}$ . The output and product market concentration difference between the common-ownership and maverick markets increases with the degree of common ownership  $\kappa$ .*

These results constitute an unified theoretical framework that can rationalize relationships between common ownership and a host of firm-, market-, and industry-level outcomes including prices, quantities, product market concentration, costs, markups, and profits while also explicitly recognizing agency conflicts between shareholders and managers. As such, it provides the first formal mechanism (or “theory of harm”) that applies to the common ownership debate as it currently stands. Table 3 summarizes our theoretical results and their relation to the empirical evidence.

Our model uses prices (or quantities) as the competitive actions through which firms affect the profitability of their competitors and demonstrates how these actions are driven by the strength of managerial incentives. However, other competitive actions that are in the hands of top managers, such as entry decisions or investment choices, influence the profits of competitors in very similar ways. Therefore, our theoretical framework also relates, albeit more loosely, to another set of empirical results. Newham et al. (2019), Xie and Gerakos (2020), and Ruiz-Pérez (2019) find

Theory	Prediction	Level	Empirical Evidence
Prop. 1 & 2	Incentives (−)	Firm	Section 6
	Costs (+)	Firm	Aslan (2019)
	Markups (±)	Firm & Market	Aslan (2019), Koch et al. (2020), Backus et al. (2021)
Coro. 1	Profits (+)	Firm	Boller and Scott Morton (2020)
Coro. 2	Prices (+)	Firm & Market	Azar et al. (2018), Park and Seo (2019), Aslan (2019), Azar et al. (2019), Torshizi and Clapp (2019)
Coro. 3	Output (−)	Market	Azar et al. (2018)
	Concentration (−)	Market	Azar et al. (2018), Azar et al. (2019)
Coro. 4	Governance (−)	Firm	Bubb and Catan (2018), Heath et al. (2020)
	Entry (−)	Firm & Market	Newham et al. (2019), Ruiz-Pérez (2019), Xie and Gerakos (2020)
	Investment (−)	Industry	Gutiérrez and Philippon (2018)

**Table 3.** Theoretical Predictions and Empirical Evidence: −, +, and ± respectively denote negative, positive, and ambiguous relationships between common ownership and the relevant variable.

evidence that common ownership leads to less aggressive entry decisions in pharmaceuticals and airlines. Gutiérrez and Philippon (2018) document that quasi-indexer ownership appears to lower investment.<sup>21</sup>

In summary, our theoretical analysis offers a plausible channel, namely simple and commonly used profit-based managerial incentive contracts, through which increases in common ownership can lead to less competitive product market behavior. Importantly, our model does not require any communication or even cooperation between the different owners themselves or their managers, or between product market competitors, nor does it require that top managers or pricing specialists know anything about the identities or motives of their owners. They merely need to know and respond to their own incentives.

<sup>21</sup>This latter prediction can be reversed in a model of investment in advertising or innovation, because the impact on other firms' profits can be positive due to increased product differentiation or technological spillovers. See López and Vives (2018) and Antón et al. (2018) for theoretical models and empirical evidence along these lines.

## 4 Discussion

We now evaluate the plausibility of the proposed mechanism and discuss its implications for interpreting existing evidence from corporate governance and industrial organization. We also discuss the robustness of the model with respect to different assumptions about strategic interaction between firms. Section A.1 in the appendix presents additional discussion of the form of strategic competition, timing and observability assumptions, endogenous market shares, managerial risk aversion, performance measures, product market differentiation, concentration, and vertical relationships.

### 4.1 Governance Costs and Managerial Perks

Our theoretical model employs a canonical principal-agent setup in which the principal (the majority shareholder) sets incentives for the agent (the manager). This same setup has been used as the workhorse model for much of the executive compensation literature and is often referred to as the *contracting view*.

However, such a managerial incentive design problem may convey the idea that lower managerial incentives (and hence anticompetitive product market outcomes) are deliberately and purposefully chosen by common owners. One of the strengths of our model is that it does not require common owners to take the initiative when designing incentives. It is sufficient for common owners to remain passive and thus not push for performance-sensitive compensation to the extent that an undiversified owner (or a diversified owner with holdings in other industries) would. In other words, our model does not distinguish between the absence of an undiversified shareholder pushing for performance-sensitive compensation (e.g., Richard Branson and Stephen Freidheim at Virgin America) and the presence of a large common owner who does not actively push for any particular compensation plan at all, but merely lets executives get away with high and performance-insensitive pay by not voting against the compensation plan proposed by management. This is consistent with the *skimming view* of executive compensation first formulated by Crystal (1992) and formally investigated by Bertrand and Mullainathan (2000) and Bertrand and Mullainathan (2001).<sup>22</sup>

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<sup>22</sup>In our model the contracting and the skimming view both lead to greater managerial slack, but they differ with respect to whether managers capture rents in equilibrium. Our model can also straightforwardly account for

To formalize the idea that common owners have weak incentives to undertake active governance decisions, because being passive is sufficient, consider the following variant of the model. In order to be able to design a managerial incentive contract, a firm’s (majority) owner must pay a corporate governance cost  $g > 0$ . If the owner does not pay  $g$ , the manager is given a flat wage  $w_i = s_i$  without any incentive component (i.e.,  $\alpha_i = 0$ ) that satisfies his outside option  $\bar{u}$  and causes him to exert the minimal level of effort. This assumption is consistent with the view that in firms with weak corporate governance managers have lower incentives, exert lower effort, and are allowed to “enjoy the quiet life” (Bertrand and Mullainathan, 2003).

It is straightforward to show that a common owner with a sufficiently large value of  $\kappa$  will be unwilling to pay the governance cost  $g$ , whereas undiversified owners (or diversified owners with holdings in other industries) will be more willing to pay  $g$ . As a result, common owners will endogenously choose to be passive and not engage in the design of managerial incentives.

**Corollary 4.** *If  $\kappa < \kappa^*$ , the majority owner pays the governance cost  $g$  to design executive compensation, resulting in the equilibrium incentives given in Propositions 1 and 2. If  $\kappa \geq \kappa^*$ , the majority owner does not pay the governance cost  $g$ , resulting in lower managerial incentives, lower managerial effort, higher costs, and higher prices.*

The governance passivity of common owners offers an explanation for why the machine learning analysis of shareholder votes of Bubb and Catan (2018) categorizes the largest 5 common owners (BlackRock, Vanguard, State Street, Fidelity, and T. Rowe Price) as belonging to the “traditional governance party” of mutual funds. This party is distinctly deferential to management and is generally supportive of management on compensation proposals of all stripes, including say-on-pay proposals specifically. Corollary 4 is also consistent with the empirical results of Heath et al. (2020) and Schmidt and Fahlenbrach (2017). Heath et al. (2020) document that index funds are ineffective monitors who are less likely to vote against firm management on contentious governance issues and do not act to improve corporate governance through their vote or engagement. Schmidt and Fahlenbrach (2017) find a worsening of governance due to increases in passive ownership.

Finally, our results also hold for another model variant in which the manager can extract private benefits, receive perks, or divert funds to himself, all actions that raise the firm’s costs. In such a model, increasing the incentive slope  $\alpha_i$  gives the manager a stronger incentive to increase firm

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managerial rents by replacing the individual rationality constraint in (9) with a shareholder “outrage constraint” (Bebchuk and Fried, 2006).

profits while discouraging him from extracting private benefits. Therefore, any owner would like to design performance-sensitive compensation plans. However, as before, the incentive to design such performance-sensitive compensation structures is weaker for a common owner, because flatter compensation also leads to less aggressive product market behavior and therefore higher profits for other firms that are also owned by the same common owner.

## 4.2 Plausibility and Implications of the Mechanism

In our model, all that is necessary for common ownership to differentially influence market-level prices is that top managers choose firm-wide, productivity-improving efforts according to the simple profit-based incentive contracts given to them by their respective owners. Crucially, our theoretical results do *not* rely on (i) owners using sophisticated market-level incentives to steer competitive behavior differentially in different markets, (ii) top managers’ knowledge of the underlying ownership structures, (iii) top managers making market-specific strategic choices, or (iv) market-level specialists being aware of different owners’ differential portfolio incentives or of top managers’ preferred strategic choices. In practice, common ownership may operate through much more direct channels than executive compensation (e.g., active intervention in strategic choices of firms, by either undiversified activists or common owners), but these channels are not necessary at all for common ownership to have the anticompetitive product market effects documented in previous empirical work.

Our theoretical results are in stark contrast to widespread misconceptions about the mechanism of common ownership among scholars in corporate finance, law & economics, and in legal academia, as well as among legal practitioners. For example, in law & economics a series of papers ([Bebchuk et al., 2017](#); [Bebchuk and Hirst, 2019](#); [Hirst and Bebchuk, 2019](#)) have argued that because common owners such as index fund managers have “incentives, which would lead them to limit intervention with their portfolio companies [...] it is implausible to expect that index fund managers would seek to facilitate significant anticompetitive behavior.” Our theoretical framework explains why common owners have an incentive to remain passive and not to intervene with portfolio companies, so we agree with the first part of that statement. However, as we have shown, it does not follow that this passivity makes the anticompetitive effects of common ownership implausible. In our model, it is precisely the lack of intervention when setting high-powered incentives for top managers (or “excessively deferential treatment of managers,” as [Bebchuk and Hirst \(2019\)](#) call

it) that leads to less competitive product market behavior. In other words, there is no paradox between favoring more effective engagement by institutional investors and being concerned about the anticompetitive effects of common ownership. Weak governance and weak competition are jointly optimal for common owners. This insight is important, because it calls into question policy prescriptions that aim to reduce common owners' governance efforts. Within our model, such an intervention would weaken both governance and competition at the same time.

In a related vein, [Hemphill and Kahan \(2020\)](#) question the plausibility of executive compensation as a possible mechanism through which common ownership can affect product market competition, because “across-the-board strategies, such as the avoidance or suppression of pay-for-performance compensation structures, result in a wholesale dilution of incentives to maximize firm value.” They further argue that “compensation-related mechanisms do not give [common owners] an effective method to increase portfolio value because they weaken managers' overall incentive to compete.” But as we have shown, it is exactly this blunting of “across-the-board” managerial incentives which weakens managers' incentive to enhance productivity and ends up affecting product market outcomes. Similarly, in the legal practitioner space, critics of the common ownership literature have incorrectly claimed that in order for common ownership to generate the observed product market variation, “the manager has to (i) know what the owners' specific interests regarding specific competitive actions are, and (ii) decide how much weight to give each owner's preferences in deciding what to do” ([Kuhn and Caroppo, 2019](#)). As we have shown, the top manager does not need to know anything other than the incentive contract given to him.

Our model also produces new insights for analyzing corporate governance decisions. When firms interact strategically in the product market, from the perspective of portfolio value optimization, it may be optimal for a common owner to act like a “lazy owner,” a behavior that is often associated with bad corporate governance. In other words, good governance—in the sense of measures that promote efficiency and shareholder returns from the perspective of an individual firm—imposes an externality on product market rivals. Therefore, common owners of product market rivals may optimally provide reduced levels of governance interventions, even though they lead to lower productivity, higher costs, and reduced operating performance of any individual firm, as documented by [Giroud and Mueller \(2010\)](#) and [Giroud and Mueller \(2011\)](#). Understanding the new rationale we provide is important for policy decisions: it is not clear that discouraging institutional investors from engaging in corporate governance activities will improve competition between

portfolio firms. Indeed, it might both harm the quality of corporate governance and further reduce competition through less efficient firms and hence reduced output. Breaking up asset managers—rather than reducing the extent of within-industry diversification—might have a similarly adverse effect on both governance and competition. Put differently, our theoretical analysis suggests that there is no conflict in objectives between corporate governance and competition policy.

Finally, our model highlights the importance of recognizing the principal-agent moral hazard problem that underlies the relationship between owners and top managers in studies of common ownership. As in standard principal agent models, our managers’ interests diverge from those of their owners, and these diverging interests cannot be fully aligned with the incentive contracts given to managers. Therefore, in equilibrium, owner interests (i.e.,  $\phi_i$  and in particular the profit weights  $\kappa_{ij}$ ) do not perfectly translate into owners’ desired product market behavior, which is in the hands of managers and pricing specialists who are compensated based on  $\pi_i$ . As a result of this principal-agent problem, the common ownership effects on product market behavior are more muted than what would be implied by a model that simply assumes that each firm acts exactly in accordance with the profit shares of its (horizontally diversified) owners. This is also in line with findings by [Ruiz-Pérez \(2019\)](#) and [Backus et al. \(2021\)](#).

Using a structural model of the ready-to-eat cereal industry, [Backus et al. \(2021\)](#) document that an exact version of the common ownership hypothesis without agency conflicts, in which firms directly choose prices according to the profit weights  $\kappa_{ij}$  of their common owners, yields implied marginal costs that would be much too low (or even negative) and markups that would be much too high. Such large markup effects of common ownership would also obtain in our model if investors could directly choose prices rather than having to indirectly raise prices through setting weaker managerial incentives and thereby incurring the productive inefficiency of higher costs. However, [Backus et al. \(2021\)](#) do not reject modified versions of their model in which 30% or less of the effect of exact common ownership is transmitted into firm pricing behavior.

Similarly, [Ruiz-Pérez \(2019\)](#) finds that a model of exact common ownership, in which airlines make entry and pricing decisions exactly according to the profit weights of their (horizontally diversified) shareholders, only does as well as a model of completely separate ownership. However, a hybrid model in which airlines act according to shareholder portfolio profit weights (i.e.,  $\max \phi_i$  as in equation (8)) for entry decisions and then choose prices to maximize just their own firm profits (i.e.,  $\max_{p_i} \pi_i$  as in equation (7)) fits the data even better.

## 5 Data

Our theoretical framework yields testable implications for the relationship between common ownership and explicit top management incentive slopes. To test the prediction that common ownership is negatively related to the sensitivity of top management economic incentives against the null hypothesis that common ownership does not affect compensation structure, we require data on wealth-performance sensitivity and ownership, as well as a robust definition of what constitutes product market competitors. In what follows, we first detail the data sources used to construct our variables and then describe how we measure common ownership. Unless otherwise stated, our sample covers the time period between 1992 and 2019.

### 5.1 Data Description

#### 5.1.1 Executive Compensation

The empirical literature has used three leading measures of wealth-performance sensitivity. [Baker and Hall \(2004\)](#) and [Edmans et al. \(2009\)](#) provide theoretical guidance on when each measure is appropriate. They show that the relevant measure depends on whether CEO productivity is additive, linear, or multiplicative for firm profits.

First, [Edmans et al. \(2009\)](#) measure incentives as the dollar change in CEO wealth for a percentage change in firm value divided by annual pay. We denote this measure as WPS EGL ( $B^I$  in [Edmans et al. \(2009\)](#)). This measure is appropriate if CEO productivity has a multiplicative effect on firm profits (and, in turn, compensation), as it does in our model where managerial productivity improvements lead to both a margin improvement (see equation (3)) as well as an expansion in firm output due to lower prices (see equations (2) and (11)). For this reason, WPS EGL is our primary measure of managerial incentives.<sup>23</sup> Second, [Jensen and Murphy \(1990\)](#) measure managerial incentives by the change in CEO wealth for a \$1,000 increase in firm value (i.e., a dollar-dollar measure) and we denote this measure as WPS JM ( $B^{II}$  in [Edmans et al. \(2009\)](#)). If managerial productivity were constant in dollar terms regardless of firm size (e.g., if managerial effort were just an additive term in the firm profits in equation (4)), WPS JM would

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<sup>23</sup>Furthermore, [Edmans et al. \(2009\)](#) deem WPS EGL “the preferred empirical measure of incentives,” providing empirical validation for its superiority over the other two potential measures and showing that it allows for straightforward comparability across firms and over time.



be the appropriate measure of managerial incentives. Third, [Hall and Liebman \(1998\)](#) measure incentives as the dollar change in CEO wealth for a percentage change in firm value. This measure is the executives’ effective dollar ownership (i.e., their “equity-at-stake”) and we denote it as WPS HL ( $B^{III}$  in [Edmans et al. \(2009\)](#)). If managerial productivity were linear in firm size (e.g., if managerial effort only improved the profit margin in equation (4) but had no impact on prices and hence output), WPS HL would be the correct measure. We use these additional two measures as robustness checks of the WPS EGL measure since they have been widely used in the incentives literature. Summary statistics about the mean, standard deviation, and distribution of the three leading wealth-performance sensitivity measures, as well as CEO tenure are given in Table 4.<sup>24</sup>

[Insert TABLE 4 Here.]

Our empirical analysis uses the ExecuComp database which contains over 3,462 companies, both active and inactive. The universe of firms covers the S&P 1500, plus companies that were once part of the S&P 1500, plus companies removed from the index that are still trading. Accounting and financial data for our controls such as volatility, leverage, and market equity comes from Compustat.

### 5.1.2 Ownership

To construct the ownership variables (see Section 5.2), we use Thomson Reuters 13Fs, which are taken from SEC regulatory filings by institutions with at least \$100m total assets under management. We augment this data by scraping SEC 13F filings following [Ben-David et al. \(2020\)](#), which resolves the issues of stale and omitted institutional reports, excluded securities, and missing holdings from 2000 onwards.<sup>25</sup> We describe the precise construction of the common ownership variables from these data in the following section.

A limitation implied by this data source is that we do not observe the holdings of individual owners, except if they are employed as officers of the company or serve on its board, in which case we complement these data with Execucomp. We assume that the remaining individual stakes of outsiders are relatively small and that in most cases they do not directly exert a significant

<sup>24</sup>We thank Alex Edmans for providing the code to compute these wealth-performance sensitivity measures.

<sup>25</sup>This correction allows us to enjoy a full set of filings by institutional holders for the large universe of Compustat firms. For a detailed description of the problems with the original 13F database by Thomson Reuters and the solutions provided by the WRDS SEC platform, see [https://wrds-www.wharton.upenn.edu/documents/752/Research\\_Note\\_-Thomson\\_S34\\_Data\\_Issues\\_mldAsdi.pdf](https://wrds-www.wharton.upenn.edu/documents/752/Research_Note_-Thomson_S34_Data_Issues_mldAsdi.pdf).

influence on firm management. The arising inaccuracies introduce measurement error and an attenuation bias toward zero in our regressions.

### 5.1.3 Industry Definitions

Following the existing corporate finance literature, our baseline specifications define industries by four-digit SIC codes from CRSP. We also investigate whether our results are robust to using Compustat SIC-4 industry definitions, as well as the 10K-text-based industry classifications of [Hoberg and Phillips \(2010, 2016\)](#) (henceforth HP). Finally, for additional robustness checks, we use coarser three-digit SIC codes. The advantage of broader industry definitions is that they may be more appropriate for multi-segment firms. Two significant disadvantages are that the market definition necessarily becomes less detailed and thus less accurate for focused firms, and that the variation used decreases.

Despite our efforts to use robust industry definitions, we acknowledge that no single one of them is perfect. In general, the assumption that an industry corresponds to a market in a way that precisely maps to theory will deviate from reality, no matter whether SIC or HP classifications are used. Moreover, using Compustat to extract sales and compute market shares means that we miss private firms in our sample. Studies that focus on one industry alone and benefit from specialized data sets for that purpose can avoid or mitigate these shortcomings. However, for firm-level studies involving multiple industries, the imperfection implied by coarser industry definitions is unavoidable. Our baseline assumption is that this deviation from the model, and from reality, leads to measurement error. We have no good reason to assume that these limitations should lead to false positives (or negatives) rather than attenuation bias. Nonetheless, it is advisable to keep these limitations in mind when deriving a quantitative interpretation of the results.

## 5.2 Measuring Common Ownership

To identify how common ownership is related to managerial incentives, we require a measure of common ownership. The existing literature provides several candidate measures of common ownership, the first of which is closely linked to the theoretical literature on common ownership, including our own model.

From equation (8), recall that the objective function of firm  $i$  is given by

$$\phi_i = \pi_i - w_i + \sum_{j \neq i} \kappa_{ij} (\pi_j - w_j)$$

where  $\kappa_{ij}$  is the weight that firm  $i$  places on its industry competitors  $j$ 's net profits,  $\pi_j - w_j$ . The weighted sum of these profit weights  $\kappa_{ij}$  across all the industry competitors of firm  $i$  is the principal object of interest in the common ownership hypothesis (Backus et al., 2020a) and therefore our main measure of common ownership. We refer to this equal- or value-weighted average of the weights on the profits of the  $n - 1$  industry competitors of firm  $i$  as  $\bar{\kappa}_i$  or simply “kappa.” More formally,

$$\bar{\kappa}_i = \frac{1}{n-1} \sum_{j \neq i} \kappa_{ij} \quad \text{or} \quad \bar{\kappa}_i = \frac{1}{\sum_{j \neq i} \omega_j} \sum_{j \neq i} \kappa_{ij} \omega_j \quad (12)$$

where the weighting  $\omega_j$  is the stock market value of firm  $j$  that competes in the same industry as firm  $i$ .

Although the average profit weight  $\bar{\kappa}_i$  is the leading measure for measuring common ownership and directly maps to the profit weights used in our theoretical analysis, it is important to verify that our empirical results are robust to using alternative measures of the extent to which a firm's most powerful shareholders care about competitor profits.

Following the frameworks of Rotemberg (1984) and O'Brien and Salop (2000), Backus et al. (2020a) show that under proportional control (“one share, one vote”), each profit weight  $\kappa_{ij}$  can further be decomposed into

$$\kappa_{ij} = \underbrace{\cos(\nu_i, \nu_j)}_{\text{overlapping ownership}} \cdot \underbrace{\sqrt{\frac{IHHI_j}{IHHI_i}}}_{\text{relative IHHI}}. \quad (13)$$

The first term is the cosine of the angle between the vector  $\nu_i$  of ownership positions  $\nu_{io}$  that owners (indexed by  $o$ ) hold in firm  $i$  and the corresponding vector  $\nu_j$  for firm  $j$ . The second term is the ratio of the “investor Herfindahl–Hirschman indices”  $IHHI_i = \sum_o \nu_{io}^2$  and  $IHHI_j = \sum_o \nu_{jo}^2$  for the owners of firm  $i$  and  $j$ .

The cosine similarity captures the overlap in ownership and is the origin of the incentive to internalize the profits of another firm. Abstracting from the possibility of large short positions, ownership shares in  $(i, j)$  are non-negative and therefore this similarity metric  $\cos(\nu_i, \nu_j)$  is re-

stricted to the  $[0, 1]$  interval. A cosine similarity of zero corresponds with no common owners while a cosine similarity of 1 corresponds to identical shareholding structure. Since this is an  $L_2$  similarity measure, the metric puts more weight on large owners than small owners.<sup>26</sup> The second source of variation in common ownership profit weights comes from the ratio of the IHHI indices and ties the theory of common ownership to the notion that investor concentration drives a wedge between control rights and cash flow rights. All other things being equal, firms with concentrated investors will place more weight on their own profits and less weight on competitor profits.

Ownership similarity is the symmetric component of the profit weight; if it increases, it will increase the objective functions of both firms in the industry. On the other hand, the relative shareholder concentration term is inherently asymmetric. To the extent that the asymmetric incentives of the profit-weight model are limited by legal restrictions or managerial behavior, empirically we may see the first-order effects of common ownership propagate through cosine similarity, as suggested by [Boller and Scott Morton \(2020\)](#). We therefore also use the equal-weighted average of the cosine similarity across all the  $n - 1$  competitors (indexed by  $j$ ) of firm  $i$  as a firm-specific measure for common ownership, which is given by

$$\overline{\text{cos}}_i = \frac{1}{n-1} \sum_{j \neq i} \cos(\nu_i, \nu_j) \quad \text{or} \quad \overline{\text{cos}}_i = \frac{1}{\sum_{j \neq i} \omega_j} \sum_{j \neq i} \cos(\nu_i, \nu_j) \omega_j. \quad (14)$$

An alternative measure we employ is the average fraction of competitor shares held by the firm's top 5 shareholders, which we call the Top 5 shareholder measure. This is a model-free measure. In particular, this firm-specific measure for firm  $i$  is defined as

$$\overline{\text{Top5}}_i = \frac{1}{n-1} \sum_o \sum_{i \neq j} \nu_{jo} \quad \text{or} \quad \overline{\text{Top5}}_i = \frac{1}{\sum_{j \neq i} \omega_j} \sum_o \sum_{i \neq j} \nu_{jo} \omega_j \quad (15)$$

where  $\nu_{jo}$  is again the ownership share of firm  $j$  accruing to shareholder  $o$  who is one of the 5 largest owners of firm  $i$ , and  $j$  indexes all of firm  $i$ 's competitors (of which there are  $n - 1$  for a given industry).

Another established and popular measure of connectivity and ownership overlap between firms comes from [Antón and Polk \(2014\)](#). It constructs a measure of common ownership that is the total value of stock held by all the common shareholders  $o$  of two industry competitors  $i$  and  $j$ ,

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<sup>26</sup>Note that the Hoberg-Phillips industry definitions also use a cosine similarity measure, which relies on the pairwise vectors of firm 10K product descriptions.

scaled by the total market capitalization of the two stocks  $i$  and  $j$ . Specifically, this pair-level measure is

$$AP_{ij} = \frac{\sum_o (S_i^o P_i + S_j^o P_j)}{S_i P_i + S_j P_j}$$

where  $S_i^o$  is the number of shares held by owner  $o$  of firm  $i$  trading at price  $P_i$  with a total of  $S_i$  shares outstanding, and similarly for the stock of firm  $j$ . We use the weighted average across all  $n - 1$  industry competitors of firm  $i$  and refer to it as the Anton-Polk (or AP) measure of common ownership:

$$\overline{AP}_i = \frac{1}{n-1} \sum_{j \neq i} AP_{ij} \quad \text{or} \quad \overline{AP}_i = \frac{1}{\sum_{j \neq i} \omega_j} \sum_{j \neq i} AP_{ij} \omega_j. \quad (16)$$

We also use the modified cross-holdings measure from [Harford et al. \(2011\)](#) (henceforth the HJL measure), which accounts for the incentives of common investors during the merger of two firms. In their setting, the shareholders of a bidding firm are more likely to internalize the effect of paying a lower takeover premium on the target firm if they also own shares of the target. To capture this externality of common ownership, they estimate each investor's relative ownership stake in the target to that of the acquirer and aggregate these relative weights across investors in the bidding firm. Specifically, this pair-level measure is given by  $HJL_{ij} = \sum_o \frac{\nu_{jo}}{\nu_{io} + \nu_{jo}}$ . We use the (weighted) average of this measure across all industry competitors of firm  $i$ , given by

$$\overline{HJL}_i = \frac{1}{n-1} \sum_{j \neq i} HJL_{ij} \quad \text{or} \quad \overline{HJL}_i = \frac{1}{\sum_{j \neq i} \omega_j} \sum_{j \neq i} HJL_{ij} \omega_j. \quad (17)$$

Finally, we use the “modified Herfindahl-Hirschman index  $\Delta$ ” (henceforth MHHID) as another measure of common ownership. This measure, originally developed by [Bresnahan and Salop \(1986\)](#) and [O'Brien and Salop \(2000\)](#), is used by regulators worldwide to assess competitive risks from the holdings of a firm's stock by direct competitors, and has been used by a number of previous empirical contributions to the literature on common ownership. Specifically, it is derived from the total market concentration (MHHI), which is composed of two parts: product market concentration as measured by HHI ( $\sum_i s_i^2$ ) and common ownership concentration as measured by MHHID. HHI captures the number and relative size of competitors and MHHID captures to which

extent these competitors are connected by common ownership. Formally,

$$\underbrace{\sum_i \sum_j s_i s_j \frac{\sum_o \nu_{jo}}{\sum_o \nu_{io}}}_{\text{MHHI}} = \underbrace{\sum_i s_i^2}_{\text{HHI}} + \underbrace{\sum_i \sum_{j \neq i} s_i s_j \frac{\sum_o \nu_{jo}}{\sum_o \nu_{io}}}_{\text{MHHID}} \quad (18)$$

where  $\nu_{io}$  is the ownership share of firm  $i$  accruing to shareholder  $o$ . An attractive feature of MHHID is that it can be micro-founded with a voting model (Azar, 2016; Brito et al., 2018). The disadvantage of this measure relative to firm-level measures of common ownership (i.e.,  $\bar{\kappa}_i$ ,  $\overline{\text{COS}}_i$ ,  $\overline{\text{Top5}}_i$ ,  $\overline{\text{AP}}_i$ ,  $\overline{\text{HJL}}_i$ )<sup>27</sup> is that MHHID may absorb relevant cross-sectional variation (of shareholder overlap between the different companies) across firms within the same industry. By looking at firm-level measures of the “effective sympathy” that one firm’s shareholders should have towards connected firms based on their portfolios, we capture more precisely the intensity of the influence of common ownership links between firms. For example, one firm in an industry of five competitors may be controlled by a single investor without stakes in competitors, whereas the other four firms are commonly owned.<sup>28</sup>

Table 4 also reports summary statistics for the different common ownership measures. For the most exhaustive description and analysis of the sizable increase of common ownership among S&P 500 firms from 1980 to 2017, see Backus et al. (2020a).<sup>29</sup>

<sup>27</sup>An omission from this list of firm-level measures of common ownership is the measure proposed by Gilje et al. (2020). This is because in their model “the measure cannot be interpreted as a profit weight” (Backus et al., 2020b) and, by assumption, it “does not allow for strategic interactions” between either managers or firms (Gilje et al., 2020). It is therefore unsuitable in our context, which explicitly links managerial incentives to investor profit weights and which is based on strategic interactions between firms.

<sup>28</sup>To address the endogeneity of market shares which are an input to MHHID, we also use an equal-weighted (rather than market share-weighted) measure of MHHID, denoted MHHID 1/N.

<sup>29</sup>However, the rise of common ownership has also been documented in a number of earlier contributions. For example, Matvos and Ostrovsky (2008) are the first to show that institutional shareholders of acquiring companies hold substantial stakes in the target companies. Harford et al. (2011) document that institutional cross-holdings between large firms have increased rapidly, mostly due to indexing and quasi-indexing. In fact, they state that “by 2005, most institutional investors in S&P 500 firms do not want corporate managers to narrowly maximize the value of their own firm. Instead, investors would see their portfolio values maximized if managers internalized a large percentage of any externalities imposed on other index firms would see their portfolio values maximized if managers internalized a large percentage of any externalities imposed on other index firms.” Azar (2012) and Gilje et al. (2020) provide evidence of the increase of common ownership at the firm-pair level, as well as using other measures.

## 6 Empirical Analysis

### 6.1 Empirical Design

The main contribution of our theoretical analysis is to provide a mechanism, namely managerial incentive contracts, through which common ownership can affect product market structure and outcomes. We thereby provide an explanation for various previously documented (but unmodeled) results in the literature. However, the central prediction of our proposed mechanism, which has not been tested thus far, is that the strength of top management incentives varies across firms by the level of common ownership of the firms they manage. We now empirically test this prediction using various measures of wealth-performance sensitivity (WPS), the most comprehensive measure of managerial incentives (Edmans et al., 2009, 2017), and several common ownership measures, as detailed in Section 5. We do not empirically investigate the theoretical predictions about the relationship between common ownership and product market outcomes for two reasons. First, some of these correlations, in particular those between common ownership and pricing, have previously been documented, as shown in Table 3. Second, a thorough empirical analysis of the model’s precise mechanism would necessitate measuring (or estimating) managerial productivity improvements and firms’ marginal costs, in addition to estimating a structural model of product market competition under common ownership in the particular industries of concern. Lastly, we do not wish to distract from the conceptual point that any governance intervention at the firm level that affects firm productivity can have product market-level consequences. Our theoretical framework does not allow us to investigate the relative quantitative importance of non-exclusive governance channels, which include engagement, pay structure, or other previously documented effects of ownership changes such as poison pills (Appel et al., 2016).

Our baseline analysis uses the following specification:

$$WPS_{ijzt} = \beta \cdot CO_{it} + \gamma \cdot X_{ijzt} + \eta_{z_2t} + \mu_i + \varepsilon_{ijzt}, \quad (19)$$

where  $i$  indexes firms,  $j$  indexes managers,  $z_4$  denotes industries at the four-digit level and  $z_2$  at the two-digit level,  $X$  is a vector of controls,  $\eta_{z_2t}$  and  $\mu_i$  are industry-year and firm fixed effects, respectively, and  $CO_{it}$  is our principal variable of interest, a measure of common ownership. Because our theoretical framework does not yield an explicit solution for the optimal managerial

incentive slope, we remain agnostic as to the specific functional form in which common ownership influences managerial wealth-performance sensitivity. We use rank-transformed measures of common ownership, including equal- or value-weighted averages of profit weights, average cosine similarity, the top 5 shareholder, the AP, and the HJL measure, as well as industry-level MHHID, to allow for straightforward comparisons. All these common ownership measures are at the firm level except MHHID, which is measured at the four-digit industry level.

In our panel regressions, we use fixed effects to difference out potentially confounding variation. For example, there could be industry-level trends in common ownership that are correlated for unmeasured reasons with trends in managerial incentive slopes. Including industry-year fixed effects ensures that the common ownership coefficient is not estimated from such correlated trends. The remaining source of identifying variation is, mainly, differences across firms in changes over time in common ownership and incentive slopes.<sup>30</sup> The firm fixed effects ensure that the results are not driven by unobserved omitted firm characteristics that happen to be correlated both with common ownership and incentive slope levels.

To make sure that our results are not driven by outliers, we winsorize our measures of compensation, sales, book-to-market, and institutional ownership at the 1% level.<sup>31</sup> All standard errors are clustered two ways, at the firm and year level (Petersen, 2009).

## 6.2 Panel Regressions

Table 5 presents results from our baseline panel regressions. Column (1) regresses the natural logarithm of wealth-performance sensitivity (WPS) on our principal measure of interest, the rank-transformed, equal-weighted average  $\bar{\kappa}_{it}$ , while controlling for size, book-to-market, volatility, leverage, and executive’s tenure with the firm, as well as using (time-invariant) firm fixed effects and (time-varying) industry-year fixed effects.<sup>32</sup> The coefficient on  $\bar{\kappa}_{it}$  is negative, -0.133, and

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<sup>30</sup>There is also remaining variation across four-digit industries within two-digit industry-years. In regressions that use MHHID as the measure of common ownership, the *only* remaining variation is across four-digit industries within two-digit industry-years. All our coefficient estimates for firm-level measures of common ownership persist if we use four-digit industry-year fixed effects instead.

<sup>31</sup>Edmans et al. (2009) winsorize several variables at 5% and 2% levels.

<sup>32</sup>In order to achieve a high correspondence between the multiplicative structure of managerial effort in our model and the empirical tests, this specification closely follows the seminal analysis of CEO incentives in Table 2 of Edmans et al. (2009). The key differences are the additional fixed effects, additional industry controls, and the common ownership measure. Because institutional ownership, as computed in Hartzell and Starks (2003), is not strongly correlated with common ownership, omission of the former variable is not likely to cause an econometric bias. Indeed, we verify that the results are no less significant when institutional ownership is included as a control.



statistically significant. That is to say, wealth-performance sensitivities tend to be significantly lower for CEOs of firms that are more commonly-owned. Column (2) uses the same specification as column (1), but instead uses the value-weighted average  $\bar{\kappa}_{it}$  as a measure of common ownership. The coefficient estimate for  $\bar{\kappa}_{it}$  is very similar in magnitude (-0.128) and also statistically significant at the 1% level. Our coefficient estimates are also almost identical when we use higher-order polynomials or quintile dummies of the firm size measure, thus assuaging concerns that the common ownership variable might be picking up a non-linear effect of firm size.

**[Insert TABLE 5 Here.]**

All specifications use firm fixed effects to remove firm-invariant characteristics and industry-time fixed effects to account for trends in WPS that are industry-specific and may change over time. For example, important events such as the tech bubble in the early 2000s or the 2008 financial crisis may have affected industry compensation practices differently across time. The inclusion of these fixed effects ensures that we avoid spurious inferences from industry-wide trends or time-invariant firm compensation policies, instead basing our inferences only on within-firm and within-year variation.

Importantly, because our regressions include firm (and industry-year) fixed effects, the results should be interpreted as within-firm (and within-industry-year) associations. It is not merely the case that firms with high common ownership have low managerial wealth-performance sensitivity versus firms with low common ownership. Rather, firms appear to change the wealth-performance sensitivity of their CEOs' compensation based on whether or not their shareholders currently place a lot of weight on the profits of industry competitors.

In order to conservatively estimate whether there is a significant panel correlation between common ownership and WPS, we present fully saturated regressions with a large number of fixed effects, which might absorb more variation than desirable to arrive at the most meaningful quantitative estimates. That said, the estimated coefficient is similar in magnitude to other first-order determinants of WPS in the literature. Shifting a firm's average profit weight from the 25th percentile to the 75th percentile of the distribution of average kappa would be associated with a 6.6% decrease ( $= e^{-0.133 \times (0.75 - 0.25)} - 1$ ) in CEO wealth-performance sensitivity. The economic significance of the estimated coefficient of common ownership on WPS is similar to that of firm volatility, which in turn matches the estimate for firm volatility in Table 4 of [Edmans et al. \(2017\)](#): a one-

standard deviation reduction in firm volatility implies a 7% decrease in CEO wealth-performance sensitivity.

This reduction in WPS can have a meaningful effect on a CEO’s wealth. Recall that WPS is the dollar change in CEO wealth for a 100 percentage point change in firm value divided by annual flow compensation. For the average CEO in our data, WPS is around 20 and average flow compensation for a CEO in the S&P 500 was \$14.8 million in 2019. For a CEO at the 75th percentile of common ownership, a 50% increase in firm value would thus increase her wealth by \$148 million. This number is almost \$10 million (or almost two thirds of their annual compensation) smaller if the firm ranks 50 percentiles lower in terms of its common ownership weights ( $6.6\% \times \$148 \text{ million} = \$9.77 \text{ million}$ ).

### 6.2.1 Alternative Industry Definitions

Our empirical analysis assumes that firms belonging to the same industry definitions compete in at least some product markets. Four-digit definitions could either be too narrow (if firms compete in multiple product markets labeled by different industry definitions) or too broad (if firms only compete in some product markets but not others, all of which belong to the same industry designation). Alternative industry definitions of a given granularity could also vary with respect to the extent to which they capture product market interactions. We now investigate to what extent our results are sensitive to alternative industry definitions.

Specifications (3) to (6) of Table 5 present evidence of the robustness of the results shown in the previous two columns to the data source used to compute industries. Columns (1) and (2), presented above, use CRSP definitions of SIC-4 codes whereas columns (3) and (4) use Compustat, and columns (5) and (6) use the Hoberg-Phillips four-digit industry definitions. The coefficient estimates for common ownership remain similar in magnitude and statistically significant in all specifications. However, the coefficient estimate of the value-weighted average  $\bar{\kappa}_{it}$  using Hoberg-Phillips industry definitions in column (6) is weakest and only statistically significant at the 10% level. We conclude that our baseline results are robust to what is considered a competitor for any given firm and to how industries are defined.

## 6.2.2 Alternative Measures of Common Ownership

Our baseline results may suffer from a concern about the particular measure of common ownership we use, namely the weighted average of the profit weights that a firm  $i$  attaches to the profits of other firms. Although this particular measure has several attractive properties and is closely related to our theoretical analysis, there is no generally accepted theory to inform corporate objectives when firms are not price takers and shareholders have interests outside the firm. Therefore, we examine how the results change as we employ several alternatives that capture to what extent firms should display “effective sympathy” to their industry competitors. First, following [Backus et al. \(2020a\)](#), we decompose the profit weights into their sub-components and compute a firm’s average of the cosine similarity with its industry competitors. Second, we calculate to what extent the top five shareholders in a firm own competitor stocks as well. Third, we use the Anton-Polk measure of common ownership. Fourth, we use the [Harford et al. \(2011\)](#) cross-holdings measure. Fifth, following the extant literature on common ownership, we use the MHHID and MHHID 1/N measures, which only vary at the industry level.

We present the results in Table 6. The results are in line with our baseline results. All measures of common ownership are significantly negatively related to CEO wealth-performance sensitivity. Note that all of the alternative common ownership measures imply even larger magnitudes for the negative association between common ownership and managerial incentives. An interquartile range move in the various alternative common ownership measures corresponds to a decrease of 8.5% ( $= e^{-0.177 \times (0.75 - 0.25)} - 1$ ) to 19.1% ( $= e^{-0.423 \times (0.75 - 0.25)} - 1$ ) in CEO wealth-performance sensitivity.

[Insert TABLE 6 Here.]

In Appendix Table B1, we further show that this pattern also holds when using alternative industry definitions. We obtain very similar coefficient estimates that are statistically significant across almost all measures of common ownership and all industry definitions.

We also investigate which of the two components of the weighted average of the profit weight  $\kappa$  is principally responsible for the negative impact on wealth-performance sensitivity. In Appendix Table B3, we show that the cosine similarity is negatively associated whereas the IHHI ratio is either insignificant or positively related. This explains why, in Table 6 and throughout our paper, the negative effect for  $\kappa$  is smaller in magnitude than for the cosine similarity. This result is in

line with the findings of [Boller and Scott Morton \(2020\)](#), who also document a stronger effect on the stock returns of index incumbents upon index inclusion of a competitor, when using the cosine similarity as a measure of common ownership.

### 6.2.3 Alternative Measures of Wealth-performance Sensitivity

Another important question regarding the evidence we have presented so far is to what extent our insights are robust to the way managerial wealth-performance sensitivities are calculated. To investigate this question, Table 7 presents the same specifications as in Table 5, but with various alternative outcome variables, providing different measures of the sensitivity of CEO wealth to firm performance.

[Insert TABLE 7 Here.]

Columns (1) through (3) use [Jensen and Murphy’s \(1990\)](#) WPS measure and columns (4) through (6) use [Hall and Liebman’s \(1998\)](#) version of WPS. The results are qualitatively similar in magnitude to those presented in Table 5 and Table 6, and are statistically significant throughout. An interquartile reduction in common ownership  $\kappa$  corresponds to a -7.8% reduction in WPS-JM and a -5.8% reduction in WPS-HL, both of which are comparable to the -6.6% reduction in the benchmark WPS-EGL measure.

In Table B2 in the appendix, we show that this pattern also holds for alternative industry definitions and alternative measures of common ownership, thus illustrating that across all dimensions (i.e., wealth-performance sensitivities, common ownership measures, and industry definitions) of the full matrix of robustness checks, our results remain consistently negative, with similar economic magnitudes and statistical significance levels.

### 6.2.4 Other Robustness Tests

Table 8 shows that when common ownership is higher the wealth-performance sensitivity of top management compensation is lower, not just for CEOs, but also for all top executives. The negative association between common ownership and wealth-performance sensitivity remains significant for all measures of common ownership, but the effect is weaker than for CEOs. One interpretation of this result is that CEOs are principally responsible for firm strategy and thus their decisions have a much greater impact on the profits of competitors than those of other top managers. Therefore,

we would expect the incentive-reducing effect of common ownership to be most pronounced for CEOs.

[Insert TABLE 8 Here.]

To check robustness with respect to the relative timing of changes in common ownership and changes in WPS, in Appendix Table B4 we present the coefficient estimates of the same specification as in our baseline regressions, but with one-year lags in the common ownership variables. Across all industry definitions and common ownership measures the coefficient estimates and standard errors are very similar to our baseline regressions, and are even slightly larger in magnitude for the Hoberg-Phillips industry definitions.

Finally, in Appendix Table B5, we consider coarser industry definitions at the three-digit level. We find again that the relationship between wealth-performance sensitivity and common ownership is negative and statistically significant throughout. However, the magnitude of the estimated coefficients is somewhat smaller than for our baseline regressions. We hypothesize that this is due to attenuation bias because three-digit industry definitions less precisely capture the extent to which members of the defined set of competitors interact in the product market.

In sum, the baseline panel results are neither driven by the industry definition, nor by the measure of common ownership, nor by the measure of wealth-performance sensitivity we use. However, one might be concerned that sorting of executives with particular characteristics and preferences could be driving the results. For example, less aggressive CEOs might sort into firms that are held by common owners who, for an unexplained reason (but not their economic incentives) also systematically offer “flatter” compensation packages. Our interpretation is not challenged by this plausible explanation: the purpose of the paper is to show that in firms whose largest owners are widely diversified, top managers receive less performance-sensitive compensation. Given that this sorting hypothesis is part of the narrative we propose, we do not intend to challenge this interpretation.

### 6.3 Difference-in-differences Design Using S&P 500 Additions

There is a key difference between our panel regression analysis and our theoretical analysis. In the model, ownership is assumed to be exogenous, but in the data, ownership could be endogenous. The panel regression coefficients may therefore not have the interpretation that common

ownership leads to lower managerial wealth-performance sensitivities. For example, it could be the case that unobserved expected changes in firms' product market strategies drive both changes in common ownership and changes in the structure of executive compensation. To investigate to what extent the correlations reported so far have a causal interpretation, we employ a strategy (first used by [Boller and Scott Morton \(2020\)](#)) that is based on shocks to common ownership due to index additions of competing firms. Specifically, we examine whether the negative correlation between common ownership and managerial wealth-performance sensitivity persists when we use only variation in common ownership that is caused by index additions of industry competitors.<sup>33</sup>

S&P500 additions have been extensively used as a shock to ownership in the empirical literature over the past two decades.<sup>34</sup> There are two fundamental criticisms of using index inclusion as a shock to a particular firm's (common) ownership. First, firms are selected from a committee to be added to the S&P500, and hence the decision can be somewhat affected by the recent performance of the company. Second, once the firm is added to the S&P500, there are many confounding effects observed: the company becomes more visible and receives more attention from analysts and the media, in addition to experiencing a change in ownership. [Lewellen and Lowry \(2020\)](#) further note that common ownership of firms newly added to the S&P500 increases, but so does institutional ownership, while block ownership decreases. The change in common ownership weights of newly added firms is not a suitable strategy for identifying common ownership effects.

To avoid these concerns, we employ a different identification strategy, pioneered by [Boller and Scott Morton \(2020\)](#). We use the addition of a stock  $j$  in the S&P500 as a treatment shock to the common ownership weights of *its industry competitors  $i$  that are already in the S&P500*. The addition does not cause a change in ownership of these index incumbent competitors; their institutional ownership and block ownership is unaffected. However, as [Boller and Scott Morton \(2020\)](#) show (and as we confirm in our own analysis), the common ownership weights  $\kappa_{ij}$  the investors of these competitors  $i$  put on their newly added rival  $j$  do change, simply as a result of their investors adding the index entrant to their portfolios. We investigate to what extent the structure of the treated firms' executive pay packages changes when compared to control firms

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<sup>33</sup>[Lewellen and Lowry \(2020\)](#) as well as [Egen \(2019\)](#) criticize the use of various instruments that the previous literature has used to identify firm-level effects of common ownership, in particular the addition of a firm to the S&P500 as a treatment, the use of the BlackRock-BGI merger for identification of firm-level effects, institutional mergers, and Russell index reconstitutions. We do not use any of the identification techniques they scrutinize.

<sup>34</sup>See [Afego \(2017\)](#) for a comprehensive review of the literature on index inclusions more generally, and [Boller and Scott Morton \(2020\)](#) for its use as a shock to common ownership in particular.

that are unaffected by the same index inclusion because they are not in the same industry as the newly included firm.<sup>35</sup>

For illustration, consider an industry with three firms (A, B, and C), two of which (A and B) are already in the S&P500. When C is added to the index, index funds that already own shares in A and B will be forced to buy shares in C as well. As a result, both A and B will experience an increase in common ownership weights, whereas control firms outside the industry do not experience a change in common ownership weights. C is excluded from the analysis. Given the dearth of theoretical guidance, our empirical implementation is agnostic about the particular functional form by which shareholders' economic interests in the newly added competitor change. We limit ourselves to testing if there is an effect of a treatment with regards to whether common ownership increases.

In the period 1994-2019 we identify 379 additions to the S&P500. [Boller and Scott Morton \(2020\)](#) show that the effect on peers is more pronounced when there is a true addition (the company added was not previously in the S&P400 or the S&P600) rather than a promotion (the added company was previously in the S&P400 or the S&P600). We therefore focus exclusively on 289 true index additions. We use a difference-in-differences approach and investigate the impact of the additions on WPS, during an event window of five years before and after the addition. For each index addition, we identify as treated firms those that are in the same SIC-4 industry as the added firm and that are already members of the S&P500. The control firms are those firms that are in the S&P500 but not in the same SIC-4 industry as the added firm, and that do not experience an inclusion in their industry in the same year of the inclusion event. This leaves us with 163, 179, and 151 true index additions with a sufficient number of pre- and post-inclusion years for the CRSP, Compustat, and Hoberg-Phillips industry definitions, respectively.

**[Insert FIGURE 3 Here.]**

Figure 3 shows that the index inclusion of a direct industry competitor shifts the distribution of the average kappa (left panels) and cosine similarity (right panels) of treated firms (i.e., those in the same industry that were already in the index) to the right, for all industry definitions. The

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<sup>35</sup>Index additions of competitors could change short-term hedging demand for a incumbent firm's stock. However, we are not aware of evidence that competitor index additions have longer-term effects on index incumbents that would be relevant in our setting. Furthermore, such effects would confound our strategy only if these factors were also correlated with changes in wealth-performance sensitivity.

average kappa and cosine similarity of the index incumbent firms are lower before (solid blue line) than after (dashed red line) the index inclusion of a direct industry competitor.

These figures, which corroborate earlier findings by [Boller and Scott Morton \(2020\)](#), indicate that treated companies experience an increase in common ownership when they are treated. However, we are also interested in whether treated firms experience an abnormally strong increase in common ownership when they are treated. Table B6 in the appendix reports the output from regressions of the change in common ownership, as measured by cosine similarity, on a treatment dummy, as well as on firm and year fixed effects. The estimate is identified from variation within each firm in the change of common ownership. The results indicate that treated firms experience an abnormally strong increase of common ownership when they are treated, compared to other firms in the same year, and compared to their usual change in common ownership in other years.

We compare the WPS of treatment versus control firms before and after the inclusion event using the following specification:

$$WPS_{ijzt} = \alpha \cdot Treat_{ijz_4} + \beta \cdot Treat_{ijz_4} \cdot Post_{it} + \gamma \cdot X_{ijzPre} + \phi \cdot X_{ijzPre} \cdot Post_{it} + \eta_i + \mu_t + \iota_x + \varepsilon_{ijzt}, \quad (20)$$

where  $i$  indexes firms,  $j$  indexes managers (CEOs),  $z_4$  denotes industries at the four-digit level,  $t$  indexes years,  $x$  indexes index inclusion events,  $X_{ijzPre}$  is a vector of controls measured in the year of the addition (to avoid using potentially endogenous post-treatment variation in controls), and  $\eta_i$ ,  $\mu_t$ , and  $\iota_x$  are the firm, year, and inclusion fixed effects, respectively. The estimation is run on a sample with five pre- and five post-years of the event treatment year.  $Post_{xt}$  is, for any given inclusion event  $x$ , a dummy variable equal to 1 for the year of the inclusion event and all years after, and 0 for the years before.  $Treat_{ijz_4}$  is a dummy variable equal to 1, for all sample years, if firm  $i$ , which is already in the index, experiences the index inclusion of a product market competitor (i.e., a firm with the same four-digit industry  $z_4$  as firm  $i$ ) during the sample period, and 0 otherwise. The firm being added to the index is excluded from the sample and is neither “treatment” nor “control” for the particular inclusion event.

A further explanation is in order to understand the remaining identifying variation. The key is to view every addition as a separate event. Recall the above example industry featuring firms A, B, and C. When C is added to the index, the treatment dummy takes the value of 1 for firms A and B, whereas it is zero for all other sample firms—for all years of the sample. If in another industry (featuring firms X, Y, and Z), Z is added to the index in the same year when C is added,



the treatment dummy is 1 for X and Y, but zero for all other firms—except A, B, and C, which are removed as controls because their industry experienced an inclusion in the same year. If the inclusion of Z occurs in a different year than the inclusion of C, then A, B, C, each serve as controls. As a result, there is within-firm, across-event variation in whether the firm is treated, or whether it belongs to a control. Because inclusions happen in multiple years, there is also within-firm variation over time in whether it is treated or not. Therefore, firm and year fixed effects ( $\eta_i$  and  $\mu_t$ ) are not absorbed in the above design.  $Post_{xt}$  is a dummy that is specific to an inclusion event, and therefore does not get absorbed by year fixed effects either. In contrast, any given inclusion event assigns all firms to either the treatment or control group. Therefore, the treatment dummy is absorbed by firm fixed effects. Lastly, some specifications include inclusion fixed effects,  $\iota_x$ . This serves the purpose of taking out potentially omitted variation across firms and over time that correlates with both WPS and the incidence of additions that may be heterogeneous across firm. The remaining variation is differences across firms in within-firm variation of common ownership over time that is due to the index inclusion of industry competitors.

Table 9 shows that following the index inclusion of a direct competitor that was previously not in the index, the WPS of CEO compensation at index incumbent firms operating in the same industry declines by 16.1% ( $= e^{-0.176} - 1$ ). This result is estimated using the same set of controls as our panel regressions, as well as firm and year fixed effects. Columns (2), (4), and (6) report results with inclusion fixed effects, which lead to only small changes in the coefficient estimates. Columns (3) to (6) further show that these results are also very similar for alternative four-digit industry definitions based on Compustat and Hoberg-Phillips. As in our baseline estimations, the incentive-reducing effect is smallest in magnitude for the Hoberg-Phillips industry definitions, for which the decline in WPS is equal to 10.2% ( $= e^{-0.108} - 1$ ).

**[Insert TABLE 9 Here.]**

Figure 4 plots the estimated effect of the index inclusion of an industry competitor on WPS over time. First, it shows that the negative effect of the index inclusion of a competitor on CEO WPS is not present before the inclusion of the competitor into the index. The pre-inclusion coefficient estimates are consistently insignificant. Second, it shows that the negative effect on CEO WPS is gradual. It increases in magnitude over time following the competitor’s index inclusion and is consistently statistically significant for the post-competitor-inclusion years.<sup>36</sup>

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<sup>36</sup>Although data limitations, industry definitions, and the complexity of multidimensional contracts make it

[Insert **FIGURE 4** Here.]

Finally, the incentive-reducing effect of a competitor index addition is only measurable for true additions to the index, but not for promotions from a similar index. [Boller and Scott Morton \(2020\)](#) show that such promotions are not followed by a similarly large increase in common ownership as true additions, and they do not find significant stock return reactions for these promoted companies' stock returns either. Similarly, we find that there is no statistically significant increase in common ownership due to additions and that wealth-performance sensitivity does not decrease significantly for the index incumbents following the promotion of an industry competitor to the index. We view these results as an informative placebo exercise because they show that the reduction in WPS is not a mechanical consequence of the index addition of a competitor. As predicted by our theory, an associated ownership change appears to be necessary to obtain our result.

We therefore conclude that the index inclusion of a direct industry competitor increases common ownership and thereby decreases the WPS of CEO compensation. This result allays the empirical concern that endogenous ownership confounds the interpretation of the negative correlation between common ownership and managerial incentives reported in our panel regressions.

The strategy also allays the concern that other features of ownership, such as block ownership, institutional ownership, or passive ownership could be the true drivers of our results. The ownership structure of the treated firm does not change as a result of a competitor being added to the index—only the other portfolio components of the treated firms' owners change. Therefore, these difference-in-difference results are unlikely to be driven by omitted features of firm ownership.

That said, challenges to a causal interpretation of the difference-in-differences result remain. The fact that common ownership seems to cause reductions in performance-sensitive pay is not necessarily evidence of the channel highlighted in the theory. It is just one of the theory's predictions. A simple alternative story is that common owners have lower per-firm costs of monitoring when they own more firms in the same industry, and therefore can reduce performance-sensitivity

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difficult to test systematically for changes in the actual structure of compensation contracts conditional on the addition of a rival firm into the S&P 500, there is anecdotal evidence. For example, United Airlines was added to the S&P 500 in late 2015. In 2016, American Airlines, which was already in the S&P 500, significantly changed its executive compensation contract to focus on profit margins (which typically decrease with quantity produced) rather than the earlier focus on market share and consumer satisfaction metrics. In our data, this also coincides with a reduction (starting in 2016 and increasing in subsequent years) in the wealth-performance sensitivity measure that we use.

of compensation. However, this alternative story would not at the same time explain intra-industry and intra-firm cross-market variation in product prices as well as a large set of other empirical facts as our explanation does.

## 7 Conclusion

In this paper, we examine how shareholder interests affect optimal managerial incentive contracts under strategic product market competition. Our theoretical framework provides a unified explanation for a large set of empirical facts and predicts that the sensitivity of top managers' wealth to their firm's performance is weaker when the firm's largest shareholders are also large shareholders of the firm's competitors. The resulting weaker managerial incentives can soften competition across different product markets within the same industry, in ways that are consistent with prior empirical evidence.

Although our model focuses on product market competition as one particular channel through which firms' interaction can affect the steepness of incentives, our theoretical conclusions about common ownership reducing the performance sensitivity of managerial incentives also hold more generally. Any setting in which governance interventions encourage managers to make strategic choices that have negative repercussions for the profits of other firms will yield similar predictions. This channel is economically distinct from an alternative reason for relatively weak governance by index funds emphasized by [Bebchuk et al. \(2017\)](#), [Bebchuk and Hirst \(2019\)](#), and [Gilje et al. \(2020\)](#), namely the higher cost of engagement due to a large number of portfolio firms.<sup>37</sup>

Our model shows that unilateral incentives arising from managerial compensation can be a mechanism through which common ownership can influence product market competition. Although our empirical results are consistent with this mechanism, they do not prove that managerial incentives are the primary mechanism, let alone the only mechanism, that can cause intra-industry market-level correlations between common ownership and product market outcomes, as

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<sup>37</sup>In contrast to these authors, [Lewellen and Lewellen \(2018\)](#) quantitatively estimate that “institutional investors often have strong incentives to be active shareholders,” which may explain why the largest asset management firms spend increasing resources on governance. At the same time, [Edmans et al. \(2019\)](#) theoretically argue that common ownership leads to greater price informativeness and strengthens corporate governance. These papers investigate the role of common ownership of firms whose strategic decisions do not affect other firms. That is to say, they do not make predictions specifically related to common ownership of *product market competitors*. Thus, it is possible that common ownership strengthens the governance of unrelated firms, but weakens the governance of competing firms.

documented elsewhere in the literature. By combining standard models from corporate governance, organizational economics, and industrial organization we merely prove the existence of a plausible theoretical channel that can help organize a large set of existing empirical facts. We also provide empirical evidence that is consistent with this executive compensation mechanism of common ownership. As any theory, ours is just a candidate explanation until it is replaced by a superior theory that can explain a larger set of facts.

Our theory does not allow for common owners directly influencing firms’ competitive conduct, although anecdotes of such behavior exist.<sup>38</sup> Furthermore, we deliberately limit ourselves to studying how common ownership can affect product market outcomes when managerial incentives must solely be a (linear) function of firm profits. The anticompetitive effects of common ownership would be even more pronounced if owners could design managerial incentive schemes that contract on firm output or on measures more directly linked to output than to profits, such as profit margins or relative performance.<sup>39</sup> By showing that the common ownership mechanism can be more indirect and subtle our analysis provides a conservative lower bound for the anticompetitive effects of common ownership.<sup>40</sup>

Finally, at a more general level, our results challenge the validity of a ubiquitous and fundamental assumption in industrial organization, organizational economics, and corporate finance that has rarely been examined. The fact that firms’ ownership structures and shareholders’ competitive preferences affect the structure of managerial incentives suggests that a firm’s behavior and objectives depend on who owns the firm. Our findings may therefore motivate future studies that test hypotheses derived from alternative objective functions of the firm.

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<sup>38</sup>Mooney and Mancini (2020) report that BlackRock, Fidelity, and Amundi called on “drug companies to put aside any qualms about collaborating with rivals” in light of the COVID-19 pandemic. Shekita (2020) documents and taxonomizes 30 separate competition-related interventions by common owners in many other industries.

<sup>39</sup>Olson and Cook (2017) report on twelve oil investors’ coordinated governance intervention to change executive incentives with the aim of reducing output and increasing portfolio firm profits. Similarly, a coalition of common shareholders successfully pressured major oil competitors to commit to fixed emissions targets. In the case of Royal Dutch Shell, these targets require a reduction of net carbon emissions of 20% (by 2035) and 50% (by 2050). Executive pay is linked to the targets as of 2020 (Hiller and Nasralla, 2018; Crooks, 2018; Kent, 2018). See Bell et al. (2020) for a recent examination of relative performance incentive contracts for top managers.

<sup>40</sup>Several large institutional investors such as BlackRock and TIAA-CREF have argued for stronger stakeholder capitalism which takes the interests of stakeholders other than owners (e.g., employees and consumers) into account and seeks to internalize the externalities that companies impose on “the society where they work and operate” (Fink, 2020), as well as to support broader goals of social responsibility (Hart and Zingales, 2017; Oehmke and Opp, 2019; Broccardo et al., 2020; Coffee, 2020), including climate change and race issues (Krueger et al., 2020; Condon, 2020; Shekita, 2020). In our analysis, we make the arguably less ambitious claim that investors influence companies to partially internalize the externalities that their corporate conduct imposes on other firms in the same investors’ portfolio.

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# Figures



**Figure 3. Distributions of kappa and cosine similarity before and after index inclusion of a competitor**  
This figure plots the distributions of kappa (left panels) and cosine similarity (right panels) before (solid blue line) and after (dashed red line) index inclusion of a competitor for four-digit CRSP (1st row), Compustat (2nd row), and Hoberg-Phillips (3rd row) industry definitions.



**Figure 4. Estimated Coefficients of S&P500 inclusion treatment indicator interacted with year fixed-effects on WPS.**

The graph plots the estimated coefficient on interactions of the treatment indicator variable with year fixed effects. We drop the interaction for the end of the year previous to the inclusion, and thus the effect is normalized to zero for that year. We control for volatility, natural log of market equity, leverage, HHI, and natural log of tenure, each evaluated in the year previous to the inclusion, and interacted with year fixed effects. We also include firm and year fixed effects, and double-cluster standard errors at the firm and year levels.

# Tables

**Table 2.** Panel A: Virgin America’s largest shareholders.

The data are from S&P Capital IQ (Q2 2016) and reflect the shareholder structure before the merger with Alaska Airlines.

<b>Virgin America</b>	<b>[%]</b>
Richard Branson	30.77
Cyrus Capital Partners	23.52
Virgin Group Holdings Ltd.	15.34
Vanguard	2.89
BlackRock	2.25
Alpine Associates Advisors	2.11
Hutchin Hill Capital	2.09
Societe Generale	1.84
Apex Capital	1.74
Morgan Stanley	1.70

**Table 2.** Panel B: Major US airlines’ largest shareholders.

The data are from S&P Capital IQ (Q2 2016). The table is taken from [Azar et al. \(2018\)](#).

<b>Delta Air Lines</b>	<b>[%]</b>	<b>Southwest Airlines Co.</b>	<b>[%]</b>	<b>American Airlines</b>	<b>[%]</b>
Berkshire Hathaway	8.25	PRIMECAP	11.78	T. Rowe Price	13.99
BlackRock	6.84	Berkshire Hathaway	7.02	PRIMECAP	8.97
Vanguard	6.31	Vanguard	6.21	Berkshire Hathaway	7.75
State Street Global Advisors	4.28	BlackRock	5.96	Vanguard	6.02
J.P. Morgan Asset Mgt.	3.79	Fidelity	5.53	BlackRock	5.82
Lansdowne Partners Limited	3.60	State Street Global Advisors	3.76	State Street Global Advisors	3.71
PRIMECAP	2.85	J.P. Morgan Asset Mgt.	1.31	Fidelity	3.30
AllianceBernstein L.P.	1.67	T. Rowe Price	1.26	Putnam	1.18
Fidelity	1.54	BNY Mellon Asset Mgt.	1.22	Morgan Stanley	1.17
PAR Capital Mgt.	1.52	Egerton Capital (UK) LLP	1.10	Northern Trust Global Inv	1.02
<b>United Continental Holdings</b>	<b>[%]</b>	<b>Alaska Air</b>	<b>[%]</b>	<b>JetBlue Airways</b>	<b>[%]</b>
Berkshire Hathaway	9.20	T. Rowe Price	10.14	Vanguard	7.96
BlackRock	7.11	Vanguard	9.73	Fidelity	7.58
Vanguard	6.88	BlackRock	5.60	BlackRock	7.33
PRIMECAP	6.27	PRIMECAP	4.95	PRIMECAP	5.91
PAR Capital Mgt.	5.18	PAR Capital Mgt.	3.65	Goldman Sachs Asset Mgt.	2.94
State Street Global Advisors	3.45	State Street Global Advisors	3.52	Dimensional Fund Advisors	2.42
J.P. Morgan Asset Mgt.	3.35	Franklin Resources	2.59	State Street Global Advisors	2.40
Altimeter Capital Mgt.	3.26	BNY Mellon Asset Mgt.	2.34	Wellington	2.07
T. Rowe Price	2.25	Citadel	1.98	Donald Smith Co.	1.80
AQR Capital Management	2.15	Renaissance Techn.	1.93	BarrowHanley	1.52
<b>Spirit Airlines</b>	<b>[%]</b>	<b>Allegiant Travel Company</b>	<b>[%]</b>	<b>Hawaiian</b>	<b>[%]</b>
Fidelity	10.70	Gallagher Jr., M. J. (Chairman, CEO)	20.30	BlackRock	11.20
Vanguard	7.41	BlackRock	8.61	Vanguard	10.97
Wellington	5.44	Renaissance Techn.	7.28	Aronson, Johnson, Ortiz, LP	5.99
Wasatch Advisors Inc.	4.33	Vanguard	6.65	Renaissance Techn.	4.67
BlackRock	3.77	Fidelity	5.25	Dimensional Fund Advisors	3.17
Jennison Associates	3.49	Franklin Resources	4.52	State Street Global Advisors	2.43
Wells Capital Mgt.	3.33	Wasatch Advisors Inc.	4.39	PanAgora Asset Mgt.	2.22
Franklin Resources	2.79	T. Rowe Price	4.23	LSV Asset Management	2.22
OppenheimerFunds.	2.67	TimesSquare Capital Mgt.	3.91	BNY Mellon Asset Mgt.	1.84
Capital Research and Mgt.	2.64	Neuberger Berman	3.07	Numeric Investors	1.79

**Table 4.** Summary statistics for key variables.

This table reports summary statistics for the variables at the CEO level (wealth-performance sensitivities and tenure), at the firm level (performance, market equity, volatility, kappa, cosine similarity, IHHI ratio, top 5, Anton-Polk, Harford-Jenter-Li), and at the industry level (HHI and MHHID).

Variables	N	Mean	Median	Std	10%	90%
<i>CEO variables</i>						
WPS EGL	48,192	20.32	5.77	44.48	1.04	44.17
WPS JM	48,192	16.82	5.62	28.08	0.51	47.18
WPS HL	48,192	51.59	18.06	84.43	2.11	142.33
Tenure (in years)	48,651	7.39	6.00	4.73	2.00	15.00
<i>Firm and industry variables</i>						
ln(Market Equity)	47,898	7.680	7.570	1.597	5.741	9.834
Volatility	47,847	0.102	0.089	0.052	0.493	0.172
Leverage	47,704	0.242	0.219	0.214	0.000	0.498
HHI (at industry SIC-4 level)	11,225	0.459	0.427	0.249	0.151	0.851
<i>Common ownership measures (SIC-4 CRSP)</i>						
Kappa	44,571	0.327	0.238	0.947	0.070	0.544
Cosine Similarity (1st component of Kappa)	44,571	0.272	0.244	0.157	0.095	0.493
Ratio of IHHIs (2nd component of Kappa)	44,571	1.230	0.934	2.994	0.591	1.614
Top 5 Shareholder Overlap	43,673	0.073	0.059	0.055	0.014	0.158
Anton-Polk FCAP Measure	44,571	0.226	0.213	0.122	0.074	0.405
Harford-Jenter-Li Measure	44,571	0.086	0.078	0.050	0.026	0.162
MHHID (at industry SIC-4 level)	11,225	0.156	0.120	0.149	0.010	0.340

**Table 5.** Wealth-performance sensitivity as a function of common ownership.

This table presents the coefficients from regressions of the [Edmans et al. \(2009\)](#) measure of wealth-performance sensitivity (EGL) on common ownership (equal- and value-weighted  $\bar{\kappa}$ ) while controlling for firm fixed effects and industry  $\times$  year fixed effects. The universe covers all CEOs from 1992 to 2019 present in ExecuComp. We use industry definitions based on four-digit SIC codes from CRSP and Compustat as well as the Hoberg-Phillips 400 definition. Note that the Hoberg-Phillips industry definitions are available starting in 1996. Significance levels are denoted by: \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Dependent Variable	ln(Wealth-performance Sensitivity EGL)					
Industry Definition	SIC CRSP		SIC COMP		HOBERG-PHILLIPS	
	(1)	(2)	(3)	(4)	(5)	(6)
Common Ownership (Kappa EW)	-0.133*** (0.045)		-0.114*** (0.038)		-0.101** (0.042)	
Common Ownership (Kappa VW)		-0.128*** (0.042)		-0.114** (0.043)		-0.0771* (0.042)
Volatility	1.363*** (0.278)	1.370*** (0.279)	1.023*** (0.290)	1.022*** (0.290)	1.050*** (0.272)	1.051*** (0.273)
ln(Market Equity)	0.346*** (0.019)	0.348*** (0.019)	0.343*** (0.019)	0.345*** (0.019)	0.368*** (0.023)	0.369*** (0.024)
Leverage	0.0377 (0.064)	0.0384 (0.064)	0.0141 (0.061)	0.0153 (0.060)	0.0332 (0.072)	0.0348 (0.071)
HHI	-0.113 (0.072)	-0.116 (0.071)	-0.0158 (0.059)	-0.0162 (0.059)	0.0116 (0.054)	0.0150 (0.057)
ln(Tenure)	0.487*** (0.030)	0.486*** (0.030)	0.479*** (0.029)	0.479*** (0.029)	0.493*** (0.035)	0.492*** (0.035)
Observations	42,788	42,788	45,670	45,670	34,161	34,161
R-squared	0.682	0.682	0.687	0.687	0.698	0.698
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes



**Table 6.** Wealth-performance sensitivity as a function of common ownership: alternative common ownership measures.

This table presents regressions similar to those in Table 5, but in addition to  $\bar{\kappa}$  uses several alternative common ownership measures described in Section 5.2. We use industry definitions based on four-digit SIC codes from CRSP. Table B1 in the appendix repeats the analysis for Compustat and Hoberg-Phillips industry definitions. Significance levels are denoted by: \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Dependent Variable	ln(Wealth-performance Sensitivity EGL)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
CO (Kappa)	-0.133*** (0.045)						
CO (Cosine Similarity)		-0.280*** (0.048)					
CO (Top 5 Overlap)			-0.177*** (0.040)				
CO (Anton and Polk)				-0.423*** (0.073)			
CO (Harford, Jenter and Li)					-0.410*** (0.071)		
CO (MHHID)						-0.338*** (0.060)	
CO (MHHID 1/N)							-0.260*** (0.050)
Volatility	1.363*** (0.278)	1.300*** (0.275)	1.329*** (0.278)	1.253*** (0.271)	1.261*** (0.271)	1.330*** (0.277)	1.343*** (0.277)
ln(Market Equity)	0.346*** (0.019)	0.351*** (0.019)	0.346*** (0.019)	0.356*** (0.020)	0.357*** (0.020)	0.343*** (0.020)	0.342*** (0.020)
Leverage	0.0377 (0.064)	0.0345 (0.063)	0.0451 (0.064)	0.0344 (0.064)	0.0341 (0.064)	0.0389 (0.063)	0.0386 (0.064)
HHI	-0.113 (0.072)	-0.123 (0.071)	-0.149** (0.067)	-0.126* (0.070)	-0.129* (0.069)	-0.289*** (0.078)	-0.133* (0.072)
ln(Tenure)	0.487*** (0.030)	0.491*** (0.029)	0.492*** (0.029)	0.492*** (0.029)	0.492*** (0.029)	0.485*** (0.029)	0.485*** (0.029)
Observations	42,788	42,788	42,030	42,788	42,788	42,794	42,794
R-squared	0.682	0.683	0.681	0.683	0.683	0.682	0.682
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes

**Table 7.** Wealth-performance sensitivities as a function of common ownership: alternative WPS measures.

This table presents regressions similar to those in Table 5 and Table 6, but uses several alternative measures of wealth-performance sensitivity. In columns (1) to (3) the dependent variable is the Jensen and Murphy (1990) measure while columns (4) to (6) use the Hall and Liebman (1998) measure (both in natural logs). We use industry definitions based on four-digit SIC codes from CRSP. Table B2 in the appendix repeats the analysis for Compustat and Hoberg-Phillips industry definitions. Significance levels are denoted by: \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Dependent Variable	ln(WPS JM)			ln(WPS HL)		
	(1)	(2)	(3)	(4)	(5)	(6)
CO (Kappa)	-0.164*** (0.042)			-0.120** (0.046)		
CO (Cosine Similarity)		-0.258*** (0.043)			-0.192*** (0.045)	
CO (Top 5 Overlap)			-0.196*** (0.035)			-0.131*** (0.035)
Volatility	1.526*** (0.266)	1.464*** (0.266)	1.506*** (0.268)	1.734*** (0.291)	1.689*** (0.289)	1.712*** (0.288)
ln(Market Equity)	0.0724*** (0.023)	0.0753*** (0.023)	0.0717*** (0.023)	0.680*** (0.022)	0.683*** (0.022)	0.680*** (0.022)
Leverage	-0.544*** (0.061)	-0.547*** (0.061)	-0.536*** (0.061)	0.0693 (0.062)	0.0675 (0.062)	0.0726 (0.063)
HHI	-0.116* (0.061)	-0.121* (0.063)	-0.145** (0.061)	-0.0987 (0.063)	-0.103 (0.067)	-0.128* (0.064)
ln(Tenure)	0.392*** (0.026)	0.395*** (0.026)	0.398*** (0.026)	0.569*** (0.034)	0.571*** (0.034)	0.574*** (0.033)
Observations	42,788	42,788	42,030	42,788	42,788	42,030
R-squared	0.791	0.792	0.792	0.792	0.792	0.792
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes

**Table 8.** Wealth-performance sensitivity as a function of common ownership: all executives.

This table presents regressions similar to those in Table 6 with the sample now covering all top executives rather than just CEOs. We use industry definitions based on four-digit SIC codes from CRSP. Significance levels are denoted by: \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Dependent Variable	ln(Wealth-performance Sensitivity EGL)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
CO (Kappa)	-0.0468** (0.017)						
CO (Cosine Similarity)		-0.0868*** (0.016)					
CO (Top 5 Overlap)			-0.0761*** (0.014)				
CO (Anton and Polk)				-0.153*** (0.023)			
CO (Harford, Jenter and Li)					-0.153*** (0.023)		
CO (MHHID)						-0.0934*** (0.022)	
CO (MHHID 1/N)							-0.0691*** (0.018)
Volatility	-0.0439 (0.143)	-0.0576 (0.135)	-0.0857 (0.148)	-0.0669 (0.140)	-0.0647 (0.143)	-0.0538 (0.143)	-0.0512 (0.152)
ln(Market Equity)	0.368*** (0.011)	0.369*** (0.010)	0.367*** (0.011)	0.373*** (0.011)	0.373*** (0.011)	0.367*** (0.011)	0.367*** (0.011)
Leverage	0.0802*** (0.028)	0.0796*** (0.028)	0.0857*** (0.028)	0.0800*** (0.028)	0.0799*** (0.028)	0.0817*** (0.028)	0.0815*** (0.028)
HHI	-0.0618** (0.023)	-0.0653** (0.022)	-0.0576** (0.021)	-0.0683*** (0.021)	-0.0697*** (0.021)	-0.108*** (0.027)	-0.0648** (0.022)
ln(Tenure)	0.293*** (0.030)	0.295*** (0.030)	0.297*** (0.029)	0.298*** (0.030)	0.298*** (0.030)	0.293*** (0.030)	0.293*** (0.030)
Observations	231,804	231,804	226,500	231,804	231,804	231,829	231,829
R-squared	0.797	0.797	0.797	0.797	0.797	0.797	0.797
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes

**Table 9.** Wealth-performance sensitivity as a function of common ownership: difference-in-differences estimation. This table presents the difference in difference estimates using S&P500 inclusions of competitors. Firms that are already in the S&P500 index and are in an industry that experiences an addition of a competitor firm to the S&P500 index in a given year are the treatment group, and all other firms in different industries that did not experience an inclusion in the index are the control firms. The Post dummy takes value of 1 for the event year and for the five years after the inclusion, and takes value of 0 for the five years before. The controls (not shown) we use are volatility, the natural log of market equity, leverage, HHI, and the natural log of tenure and are taken as of the pre-event year. Firm and year fixed effects are included in all specifications. Standard errors are clustered two ways at the firm and year level. Significance levels are denoted by: \*\*\* p<0.01, \*\* p<0.05, \* p<0.1.

Dependent Variable	ln(Wealth-performance Sensitivity EGL)					
Industry Definition	SIC CRSP		SIC COMP		HOBBERG-PHILLIPS	
	(1)	(2)	(3)	(4)	(5)	(6)
Treat $\times$ Post	-0.176*** (0.053)	-0.176*** (0.046)	-0.152*** (0.053)	-0.152*** (0.046)	-0.108** (0.040)	-0.108*** (0.032)
Post	1.015*** (0.200)	1.030*** (0.098)	0.934*** (0.193)	0.951*** (0.097)	1.155*** (0.290)	1.169*** (0.172)
True Inclusions	163	163	179	179	151	151
Unique Treated Firms	335	335	351	351	417	417
Unique Control Firms	807	807	837	837	709	709
R-squared	0.523	0.523	0.528	0.528	0.545	0.546
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Inclusion FE	No	Yes	No	Yes	No	Yes

# A Theoretical Appendix

## A.1 Additional Discussion

### A.1.1 Form of Strategic Interaction

Although our model and its extension focus on product market competition and, more specifically, on cost-reducing productivity improvement as one particular channel through which firms' strategic interaction can affect the steepness of incentives, our conclusions about common ownership reducing the performance sensitivity of managerial incentives hold more generally. Any setting in which more performance-sensitive compensation (or, more generally, better corporate governance) encourages managers to make strategic choices that have negative repercussions for the profits of other firms owned by common owners will yield the same prediction. This is because any increase in common ownership will make common owners relatively more sensitive to the negative effects that firms' corporate actions have on their competitors, and will thus make them less willing to set performance-sensitive managerial compensation on the margin.

As we show in Appendix A.4, our results for managerial incentives are qualitatively unchanged for the case in which firms compete in strategic substitutes rather than strategic complements (i.e., set quantities rather than prices). The reason is that when firms compete in quantities, stronger managerial incentives (and the resulting lower marginal costs) similarly induce firms to expand quantity, which in turn has a negative impact on the profits of competing firms. The only quantitative change is that for any given  $\kappa$ , an owner's optimal choice of  $\alpha_i$  is larger than with strategic complements because of the opposite strategic effect on firm profits under strategic substitutes.

All of our other firm-, market-, and industry-level predictions for costs, prices, quantities, and concentration are also unchanged, with the exception of the prediction about firm-level (though not market-level) pricing. Under strategic substitutes, commonly-owned firms respond to the aggressive behavior of the maverick by producing lower quantities (and thus charging higher prices) in the maverick markets I and II than in the common ownership market III. However, in equilibrium the output of the maverick firm expands even more in the maverick markets I and II, such that the total market quantity produced is still higher and the average market price level is still lower in the maverick markets than in the common ownership market. Therefore, the market-level

predictions about prices and quantities of Table 3 remain unchanged.

### A.1.2 Timing and Observability

Our results are robust a number of different assumptions about timing and observability.

First, assume that rather than setting prices concurrently with the effort choices of top managers in stage 2, pricing specialists set prices in stage 3 after observing the effort choice  $e_i$  of the manager of their firm. Because there is a deterministic relationship between effort  $e_i$  and marginal cost  $c_i$  this is also equivalent to observing the firm's marginal cost  $c_i$ . In this case each manager  $i$ 's first order condition remains the same because each pricing specialist  $i$  is choosing  $p_i$  to maximize the profit of firm  $\pi_i$ . Thus, by the envelope theorem the new term in manager  $i$ 's first order condition stemming from the impact of  $e_i$  on  $\pi_i$  via the change in  $p_i$  is 0.

Second, assume that pricing specialists observe not just the effort choice  $e_i$  of their own manager but the entire vector of all managerial effort choices before choosing prices in stage. In that case top managers will play a pre-commitment game in productivity improvements in stage 2. Although this changes the magnitude of the incentive-reducing effect of common ownership, it does not change any of our qualitative conclusions.

Third, our results also qualitatively hold for privately observable managerial incentive contracts. As discussed by Katz (1991) the assumption that the contract between an owner and the top manager of her firm is observable to other firms is central to the literature on strategic delegation (Vickers, 1985; Fershtman and Judd, 1987; Sklivas, 1987; Fershtman et al., 1991). In those papers, the owner's main consideration for managerial incentive design is to change the competitive behavior of other firms to increase profits at her own firm. Specifically, an owner  $i$ 's net profits  $\pi_i - w_i$  indirectly benefit from distorting incentives of manager  $i$  away from own firm profit maximization because this causes other firms  $j \neq i$  to compete less aggressively in the product market. But to influence the competitive behavior of other firms it is important that incentive contracts are observable to them.

However, this strategic effect is not the main driving force in our setting. Instead, a common owner's portfolio profits  $\phi_i = \pi_i - w_i + \sum_{j \neq i} \kappa_{ij}(\pi_j - w_j)$  directly benefit from reducing managerial incentives at firm  $i$  away from the level that would obtain under own firm profit maximization focused on  $\pi_i - w_i$ . This incentive reduction increases the net profits  $\pi_j - w_j$  at other firms even without these other firms responding to the reduced managerial incentives at firm  $i$ . In other

words, in our model even without publicly observable contracts managerial incentives have a direct effect in addition to the indirect strategic effect that exists when contracts are publicly observable.

### A.1.3 Endogenous Market Shares

The endogeneity of market shares is an important feature of our theoretical framework. As we will show not only does it provide a causal interpretation for previous empirical findings, but it also identifies shortcomings in the interpretation of existing empirical work. In our model, the only cause of market-level variation in prices, output, market shares, and concentration is the firm-level variation in common ownership.

To illustrate, suppose that an econometrician ran a regression of market prices on a measure of common ownership concentration, market concentration, and controls, all of which could depend on market shares. First, in light of our model, the econometrician would be wrong to interpret (only) the common ownership coefficient as the price effect of common ownership, as many papers in the literature, including [Azar et al. \(2018\)](#) and [Azar et al. \(2019\)](#), do by assuming exogenous market shares. This interpretation is wrong in the context of our model because variation in market concentration is also driven by common ownership.<sup>41</sup> Second, the econometrician would also be wrong to interpret a price effect of variation in market shares without variation in ownership as evidence against the presence of anticompetitive effects of common ownership, as in [Dennis et al. \(2019\)](#).<sup>42</sup> This is because in our model the price effect is actually intermediated via an endogenous market structure caused by common ownership.

Although a different model may yield a different interpretation of the same evidence, at the very least our results emphasize the importance of a greater integration of empirical and theoretical research on common ownership in the future.

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<sup>41</sup>Specifications in [Azar et al. \(2018\)](#) and [Azar et al. \(2019\)](#) that hold markets shares fixed and only use variation from ownership to affect their measure of common ownership concentration show that not the *entire* effect is driven by variation in market shares—but it does not reject that *some* of the effect is.

<sup>42</sup>[Kennedy et al. \(2017\)](#) show a positive panel correlation between ticket prices and common ownership profit weights (“incentive terms” in their paper), and thereby disprove the claim by [Dennis et al. \(2019\)](#) that the positive relationship between airline ticket prices and common ownership is due to endogenous market shares. Similarly, [Park and Seo \(2019\)](#) show a positive effect of common ownership on prices in a structural model, which also rules out a decisive role of endogenous market shares.

#### A.1.4 Managerial Risk Aversion and Performance Measures

The central problem of underprovision of managerial effort in a canonical moral hazard setup derives from the fact that the principal is unwilling to provide strong incentives because this would impose too much risk on the agent and would be excessively costly for the principal. In our model, in addition to this risk cost a common-owner principal also does not want to provide strong incentives because, from her point of view, this would lead to excessive effort provision and undesirably intense product market competition. In other words, risk costs and competition-induced common ownership costs are distinct reasons for the performance sensitivity of managerial compensation that is lower than what would be (privately and socially) optimal.

In contrast to other moral hazard models of managerial effort, in our model it is neither necessary to assume that the manager is risk-averse nor that profits include a random shock. Setting risk aversion  $r$  or the variance  $\sigma^2$  equal to zero eliminates the rationale for lower incentives slopes due to risk costs, but because of the presence of common ownership does not lead to the principal “selling the firm” to the agent. Furthermore, doing so does not alter any of our theoretical predictions as long as the manager’s effort costs are sufficiently convex thereby guaranteeing an interior solution to each owner’s problem. Therefore, our model is robust to various assumptions about managerial risk attitudes and the informativeness of performance measures. More specifically, the model is not susceptible to the challenges posed by the tenuous trade-off between risk and incentives (Prendergast, 2002).

#### A.1.5 Product Market Differentiation

The incentive-reducing effect of common ownership also depends on the degree of product heterogeneity. The negative effect of common ownership  $\kappa$  on equilibrium incentives  $\alpha^*$  given to managers increases with the degree of product homogeneity  $a$ , that is  $\frac{\partial^2 \alpha^*}{\partial \kappa \partial a} < 0$ .

Recall that product differentiation influences how strongly the firms’ production decisions influence each other. When product differentiation is low ( $a$  is high) the price choice of the other firm,  $p_j$ , has a relatively large impact on demand  $q_i$ . In other words, when product differentiation is low, price decreases will lead to more business stealing. Thus, any increase in the incentives given to the manager of firm  $i$  (and the resulting decrease in marginal cost and decrease in price of firm  $i$ ) will reduce the profits of the other firm by more than if product differentiation were high. As a result, when common ownership increases in industries with relatively homogeneous products,



owners are particularly hesitant to give strong profit incentives to their manager because this would lead the manager to compete too aggressively and steal business away from other firms also owned by the owner. This empirical prediction is potentially testable in multimarket industries in which one can measure the degree of product differentiation with confidence.

Finally, this finding further highlights the importance of focusing on the right settings to study the effects of common ownership. The existing literature (e.g., [Azar et al. \(2018\)](#) and [Backus et al. \(2020a\)](#)) has emphasized that anticompetitive effects of common ownership are only measurable in a subset of markets in any given industry, and that measuring such effects requires variation across markets in the level of common ownership for identification. However, [Koch et al. \(2020\)](#) argue that the product market effects of common ownership can be identified from regressing industry price markups and industry profitability on common ownership measures using industry-level specifications similar to [Azar \(2012\)](#). Unlike [Azar \(2012\)](#) they do not find evidence that common ownership improves profitability. In contrast, our theoretical work focuses on within-firm across-market effects and our empirical work examines firm-level effects. Our paper shows that, even if one took the empirical result at face value that there is no effect of common ownership on markups, this does not imply that there are no anticompetitive effects. The anticompetitive effects in our model come from a production cost inefficiency that is caused by the combination of common ownership and agency problems, rather than an allocative efficiency that results in higher markups.

#### **A.1.6 Product Market Concentration**

In our baseline model with  $n$  symmetric firms, one can show that the incentive-reducing and price-increasing effects of common ownership are particularly pronounced when product market concentration is high (i.e., when the number of firms  $n$  is small). This is because as the number of firms grows, each firm becomes small and its negative impact on other firms through charging lower prices diminishes. As a result, common owners are less concerned about the negative side effects (i.e., lower prices) on other firms of high-powered managerial incentives when designing incentive plans. This theoretical result can explain the empirical finding of [Azar et al. \(2018\)](#) that the price-increasing effect of common ownership is bigger in airline markets with higher product market concentration. To our knowledge, our model is the first in the literature that is able to explain this empirical pattern.

Moreover, this prediction is also consistent with the empirical results on the relationship between corporate governance and product market competition. In our model, common owners exert weak corporate governance and enable the “quiet life” of top managers by making managerial compensation less sensitive to firm performance and this incentive-reducing effect is particularly pronounced in less competitive industries where it results in lower productivity and higher costs. [Giroud and Mueller \(2010\)](#) and [Giroud and Mueller \(2011\)](#) provide empirical evidence for this prediction by showing that weak corporate governance firms have lower productivity and higher costs, but only in less competitive industries.

### **A.1.7 Vertical Relationships**

Our theoretical framework focuses on a single industry and does not feature vertical relationships. However, common ownership of vertically related firms could also play a role. Indeed, several papers have documented some effects of common ownership in vertical relationships ([Geng et al., 2017](#); [Kedia et al., 2017](#)). Furthermore, product market effects of vertical common ownership may include pro-competitive effects such as the mitigation or outright elimination of double marginalization, much in the same way that vertical integration does in the outright ownership case. However, vertical integration can also have anticompetitive effects, including exclusionary conduct like foreclosure and raising rivals’ costs. For example, [Crawford et al. \(2018\)](#) provide a comprehensive welfare analysis incorporating both positive and negative effects under partial vertical integration. A similar logic would also apply to quasi-vertical integration through common ownership.

However, even if quasi-vertical integration through common ownership only has the beneficial effect of eliminating double marginalization this will not completely offset the negative horizontal common ownership effect. This is because (consumer-facing) firms will still want to charge a markup to final consumers, even if markups were reduced to zero elsewhere in the vertical chain.

Finally, even if (i) vertical common ownership does not have any anticompetitive effects, (ii) perfectly eliminates double marginalization along the vertical chain, and (iii) consumers are also shareholders, horizontal common ownership will still have anticompetitive effects as in our model. This is because consumer interests as shareholders are only fully internalized if there is perfect homogeneity (in particular with regards to equity ownership) across consumer-shareholders as shown by ([Farrell, 1985](#)). Following this line of argument about consumer-shareholder hetero-

geneity, [Azar and Barkai \(2020\)](#) show that, despite being a large majority, households in favor of competition own only 20% of all wealth whereas the small minority of households who own the vast majority of resources in the economy, oppose increasing competition.

## A.2 Baseline Model

In this section we present the proofs for Proposition 1. The first-order conditions (10) and (11) yield a system of  $2n$  linear equations which we solve for the equilibrium efforts  $e_i^*(\vec{\alpha})$  and equilibrium prices  $p_i^*(\vec{\alpha})$  of the  $n$  firms as a function of the vector of incentive slopes  $\vec{\alpha}$ . These are given by

$$e_i^*(\vec{\alpha}) = \alpha_i \quad (21)$$

$$p_i^*(\vec{\alpha}) = \frac{(A + b\bar{c})(2b + a) - b\{[2b - (n - 2)a]\alpha_i + a \sum_{j \neq i} \alpha_j\}}{(2b + a)[2b - (n - 1)a]} \quad (22)$$

and the resulting equilibrium profit  $\pi_i^*(\vec{\alpha})$  is

$$\begin{aligned} \pi_i^*(\vec{\alpha}) = \frac{b}{(2b + a)^2[2b - (n - 1)a]^2} \{ & A(2b + a) - \bar{c}[2b^2 - (n - 1)a^2 - (2n - 3)ab] \\ & + \alpha_i[2b^2 - (n - 1)a^2 - (n - 2)ab] - \sum_{j \neq i} \alpha_j ab \}^2. \end{aligned} \quad (23)$$

In stage 1 the majority owner of firm  $i$  chooses  $\alpha_i$  to maximize her objective function given by

$$\phi_i = \pi_i^*(\vec{\alpha}) - w_i^*(\vec{\alpha}) + \kappa \sum_{j \neq i} (\pi_j^*(\vec{\alpha}) - w_j^*(\vec{\alpha})).$$

Given that the individual rationality constraint of the manager is binding we have

$$s_i = -\alpha_i \pi_i^*(\vec{\alpha}) + \frac{r}{2} \sigma^2 \alpha_i^2 + \frac{q_i^*(\vec{\alpha}) e_i^2}{2} + \bar{u}$$

and hence

$$w_i^*(\alpha) = \frac{r}{2} \sigma^2 \alpha_i^2 + \frac{q_i^*(\vec{\alpha}) e_i^2}{2} + \bar{u}.$$

From the manager's incentive compatibility we have  $e_i = \alpha_i$ . Therefore, by substituting the

incentive compatibility and individual rationality constraints (and omitting the outside option  $\bar{u}$ ) the objective function of the majority owner of firm  $i$  who chooses  $\alpha_i$  can be rewritten as

$$\phi_i = \pi_i^*(\vec{\alpha}) - \frac{r}{2}\sigma^2\alpha_i^2 - \frac{q_i^*(\vec{\alpha})\alpha_i^2}{2} + \kappa \sum_{j \neq i} \left( \pi_j^*(\vec{\alpha}) - \frac{r}{2}\sigma^2\alpha_j^2 - \frac{q_j^*(\vec{\alpha})\alpha_j^2}{2} \right).$$

Taking the derivative of the owner's objective function with respect to  $\alpha_i$  yields

$$\frac{\partial \phi_i}{\partial \alpha_i} = \frac{\partial \pi_i^*}{\partial \alpha_i} - r\sigma^2\alpha_i - q_i^*\alpha_i - \frac{\alpha_i^2}{2} \frac{\partial q_i^*}{\partial \alpha_i} + \kappa \sum_{j \neq i} \left( \frac{\partial \pi_j^*}{\partial \alpha_i} - \frac{\alpha_j^2}{2} \frac{\partial q_j^*}{\partial \alpha_i} \right).$$

The resulting first-order condition can be rewritten in the following way

$$\kappa = \frac{-\frac{\partial \pi_i^*}{\partial \alpha_i} + \frac{\alpha_i^2}{2} \frac{\partial q_i^*}{\partial \alpha_i} + r\sigma^2\alpha_i + q_i^*\alpha_i}{\sum_{j \neq i} \left( \frac{\partial \pi_j^*}{\partial \alpha_i} - \frac{\alpha_j^2}{2} \frac{\partial q_j^*}{\partial \alpha_i} \right)}. \quad (24)$$

We now rewrite the expressions of the firms' equilibrium quantities and profits as  $q_i^* = by_i$  and  $\pi_i^* = by_i^2$ , where

$$y_i = \frac{A(2b+a) - \bar{c}[2b^2 - (n-1)a^2 - (2n-3)ab] + \alpha_i[2b^2 - (n-1)a^2 - (n-2)ab] - \sum_{j \neq i} \alpha_j ab}{(2b+a)[2b - (n-1)a]}$$

The derivatives of the firms' equilibrium profits with respect to  $\alpha_i$  are given by

$$\begin{aligned} \frac{\partial \pi_i^*}{\partial \alpha_i} &= \frac{2b[2b^2 - (n-1)a^2 - (n-2)ab]}{(2b+a)[2b - (n-1)a]} y_i > 0 \\ \frac{\partial \pi_j^*}{\partial \alpha_i} &= -\frac{2b(ab)}{(2b+a)[2b - (n-1)a]} y_j < 0, \forall j \neq i. \end{aligned}$$

Similarly, the derivatives of the firms' quantity choices with respect to  $\alpha_i$  are given by

$$\begin{aligned} \frac{\partial q_i^*}{\partial \alpha_i} &= \frac{b[2b^2 - (n-1)a^2 - (n-2)ab]}{(2b+a)[2b - (n-1)a]} > 0 \\ \frac{\partial q_j^*}{\partial \alpha_i} &= -\frac{b(ab)}{(2b+a)[2b - (n-1)a]} < 0, \forall j \neq i. \end{aligned}$$

Using the symmetry of the equilibrium such that  $\alpha_i = \alpha^*, \forall i$  we obtain

$$y_i = y^* = \frac{A + (\alpha^* - \bar{c})[b - (n-1)a]}{2b - (n-1)a} \equiv k_1 \alpha^* + k_2$$

where  $k_1 = \frac{b-(n-1)a}{2b-(n-1)a} \in (0, \frac{1}{2})$  and  $k_2 = \frac{A-\bar{c}[b-(n-1)a]}{2b-(n-1)a}$  which is positive given that  $\omega > \bar{c}$ .

Substituting all the derivatives into the expression for  $\kappa$  in equation (24) and noting that  $q_i^* = q^*$  and  $\pi_i^* = \pi^*$  we obtain

$$\begin{aligned} \kappa &= \frac{2b^2 - (n-1)a^2 - (n-2)ab}{(n-1)ab} + \frac{r\sigma^2\alpha^* + by^*\alpha^*}{\sum_{j \neq i} \left[ -\frac{2ab^2}{(2b+a)[2b-(n-1)a]}y^* + \frac{(\alpha^*)^2}{2} \frac{ab^2}{(2b+a)[2b-(n-1)a]} \right]} \\ &= M_1 + M_2 \Omega(\alpha^*) \end{aligned}$$

where

$$\Omega(\alpha^*) = \frac{bk_1(\alpha^*)^2 + (r\sigma^2 + bk_2)\alpha^*}{\frac{1}{2}(\alpha^*)^2 - 2k_1\alpha^* - 2k_2},$$

and

$$M_1 = \frac{2b^2 - (n-1)a^2 - (n-2)ab}{(n-1)ab}, \quad M_2 = \frac{(2b+a)(2b-(n-1)a)}{(n-1)ab^2}$$

Since  $b > (n-1)a > 0$ , it follows that  $M_2 > 0$  and  $M_1 > 1$ . We now wish to show that  $\frac{\partial \kappa}{\partial \alpha^*} < 0$ , which is the same as showing that  $\Omega(\alpha^*)$  is decreasing in  $\alpha^*$ . The numerator of the derivative of  $\Omega(\alpha^*)$  is a quadratic function of  $\alpha^*$  and is always negative if  $k_2 > 0$  which is the case, when  $\omega > \bar{c}$ .

Finally, even though we have established that  $\frac{\partial \kappa}{\partial \alpha^*} < 0$ , it is not immediately clear that  $\frac{\partial \alpha^*}{\partial \kappa} < 0$ , because there might be two meaningful solutions to the principal's maximization problem, which yields a quadratic equation in  $\alpha^*$ . However, as  $k_2 > 0$ , because  $\omega > \bar{c}$ , there is only one positive root (and one negative root). This guarantees that for each  $\kappa \in [0, 1]$  there is a unique positive  $\alpha^*$  such that equation (24) holds. This establishes Proposition 1.

### A.3 Multimarket Firm-level Variation in Common Ownership

In this section we present the proofs for Proposition 2, Corollary 2, Corollary 3, and Corollary 4. By similar algebra as before we obtain the following equations for quantities and firm profits,

$$\begin{aligned}
q_1^* &= q_{1,I}^* + q_{1,II}^* = by_{1,I} + by_{1,II} \\
q_2^* &= q_{2,II}^* + q_{2,III}^* = by_{2,II} + by_{2,III} \\
q_3^* &= q_{3,III}^* + q_{3,I}^* = by_{3,III} + by_{3,I} \\
\pi_1^* &= \pi_{1,I}^* + \pi_{1,II}^* = by_{1,I}^2 + by_{1,II}^2 \\
\pi_2^* &= \pi_{2,II}^* + \pi_{2,III}^* = by_{2,II}^2 + by_{2,III}^2 \\
\pi_3^* &= \pi_{3,III}^* + \pi_{3,I}^* = by_{3,III}^2 + by_{3,I}^2,
\end{aligned}$$

where

$$y_{i,l} = \frac{A(2b+a) - \bar{c}(2b^2 - a^2 - ab) + \alpha_i(2b^2 - a^2) - \alpha_{l \setminus i} ab}{4b^2 - a^2}$$

and  $l \setminus i$  denotes the firm which is active in market  $l$  other than firm  $i$ .

Owner 1 solves

$$\max_{\alpha_1} \quad \pi_1^* - w_1^* = by_{1,I}^2 + by_{1,II}^2 - \frac{r}{2}\sigma^2\alpha_1^2 - \frac{by_{1,I} + by_{1,II}}{2}\alpha_1^2$$

The first order condition is given by

$$2b \left( y_{1,I} \frac{\partial y_{1,I}}{\partial \alpha_1} + y_{1,II} \frac{\partial y_{1,II}}{\partial \alpha_1} \right) - r\sigma^2\alpha_1 - b(y_{1,I} + y_{1,II})\alpha_1 - \frac{b}{2} \left( \frac{\partial y_{1,I}}{\partial \alpha_1} + \frac{\partial y_{1,II}}{\partial \alpha_1} \right) \alpha_1^2 = 0$$

Owner 2 solves

$$\begin{aligned}
\max_{\alpha_2} \quad (\pi_2^* - w_2^*) + \kappa(\pi_3^* - w_3^*) &= \max_{\alpha_2} \quad by_{2,II}^2 + by_{2,III}^2 - \frac{r}{2}\sigma^2\alpha_2^2 - \frac{by_{2,II} + by_{2,III}}{2}\alpha_2^2 \\
&\quad + \kappa \left( by_{3,III}^2 + by_{3,I}^2 - \frac{r}{2}\sigma^2\alpha_3^2 - \frac{by_{3,III} + by_{3,I}}{2}\alpha_3^2 \right)
\end{aligned}$$

The first order condition is

$$2b \left( y_{2,II} \frac{\partial y_{2,II}}{\partial \alpha_2} + y_{2,III} \frac{\partial y_{2,III}}{\partial \alpha_2} \right) - r\sigma^2 \alpha_2 - b(y_{2,II} + y_{2,III})\alpha_2 \\ - \frac{b}{2} \left( \frac{\partial y_{2,II}}{\partial \alpha_2} + \frac{\partial y_{2,III}}{\partial \alpha_2} \right) \alpha_2^2 + \kappa \left( 2by_{3,III} \frac{\partial y_{3,III}}{\partial \alpha_2} - \frac{b}{2} \frac{\partial y_{3,III}}{\partial \alpha_2} \alpha_3^2 \right) = 0$$

By symmetry,  $\alpha_2 = \alpha_3$  in equilibrium. Then

$$y_{1,I} = y_{1,II} \equiv k_1 \alpha_1 + k_2 \alpha_2 + k_3$$

$$y_{2,II} = y_{3,I} \equiv k_1 \alpha_2 + k_2 \alpha_1 + k_3$$

$$y_{2,III} = y_{3,III} \equiv k_1 \alpha_2 + k_2 \alpha_2 + k_3$$

where  $k_1 = \frac{2b^2 - a^2}{4b^2 - a^2}$ ,  $k_2 = \frac{-ab}{4b^2 - a^2}$ ,  $k_3 = \frac{A - \bar{c}(b-a)}{2b-a}$ . Then the above two FOC can be simplified to

$$\left[ 4(k_1 \alpha_1 + k_2 \alpha_2 + k_3) - \alpha_1^2 \right] k_1 = \frac{r\sigma^2}{b} \alpha_1 + 2(k_1 \alpha_1 + k_2 \alpha_2 + k_3) \alpha_1 \\ \left[ 2(k_1 \alpha_2 + k_2 \alpha_1 + k_3) + 2(k_1 \alpha_2 + k_2 \alpha_2 + k_3) - \alpha_2^2 \right] k_1 = \frac{r\sigma^2}{b} \alpha_2 + (k_1 \alpha_2 + k_2 \alpha_1 + k_3) \alpha_2 \\ + (k_1 \alpha_2 + k_2 \alpha_2 + k_3) \alpha_2 - \kappa k_2 \left( 2k_1 \alpha_2 + 2k_2 \alpha_2 + 2k_3 - \frac{\alpha_2^2}{2} \right)$$

where the difference of the two equations gives:

$$\left[ 3k_1(\alpha_1 + \alpha_2) + k_2 \alpha_2 + 2k_3 + \frac{r\sigma^2}{b} - (4k_1 - 2k_2)k_1 \right] (\alpha_2 - \alpha_1) = \\ \kappa k_2 \left( 2k_1 \alpha_2 + 2k_2 \alpha_2 + 2k_3 - \frac{\alpha_2^2}{2} \right) \quad (25)$$

Before proceeding with the analysis, it is useful to present several variants of the first order conditions that are useful in establishing the final result.

**Variant 1:**

$$k_1 \alpha_1 + k_2 \alpha_2 + k_3 = \frac{k_1 \alpha_1^2 + \frac{r\sigma^2}{b} \alpha_1}{4k_1 - 2\alpha_1} \\ k_1 \alpha_2 + k_2 \frac{\alpha_1 + \alpha_2}{2} + k_3 = \frac{(k_1 + \frac{\kappa}{2} k_2) \alpha_2^2 + \frac{r\sigma^2}{b} \alpha_2 + \kappa k_2^2 (\alpha_1 - \alpha_2)}{4k_1 - 2\alpha_2 + 2\kappa k_2}$$

**Variant 2:**

$$\begin{aligned}
& 3k_1\alpha_1^2 + \left(\frac{r\sigma^2}{b} + 2(k_2\alpha_2 + k_3) - 4k_1^2\right)\alpha_1 - 4k_1(k_2\alpha_2 + k_3) = 0 \\
& \left[3k_1 + \left(1 + \frac{\kappa}{2}\right)k_2\right]\alpha_2^2 + \left(\frac{r\sigma^2}{b} + 2\left(\frac{k_2}{2}\alpha_1 + k_3\right) - (4k_1 + 2\kappa k_2)\left(k_1 + \frac{k_2}{2}\right) - \kappa k_2^2\right)\alpha_2 \\
& \quad + \kappa k_2^2\alpha_1 - (4k_1 + 2\kappa k_2)\left(\frac{k_2}{2}\alpha_1 + k_3\right) = 0
\end{aligned}$$

Several observations follow from these two variants.

1. Since the LHS of both equations in Variant 1 are positive, it follows that  $\alpha_1 < 2k_1$  and  $\alpha_2 < 2k_1 + \kappa k_2$ .
2. In the first (second) equation of Variant 1,  $\alpha_2$  ( $\alpha_1$ ) can be explicitly written as a function of  $\alpha_1$  ( $\alpha_2$ ). So, we could represent the first equation by Curve 1 and the second equation by Curve 2.
3. According to Variant 2, both curves cross  $\alpha_1 = \alpha_2$  once in the northeast quadrant. Denote the first intersection as  $\alpha^*$  and the second as  $\alpha^{**}$ . Then the following relationship holds:  $0 < \alpha^{**} < \alpha^* < 2k_1$ .

*Proof.* The intersections satisfy

$$\begin{aligned}
& (3k_1 + 2k_2)\alpha^{*2} + \left(\frac{r\sigma^2}{b} + 2k_3 - 4k_1^2 - 4k_1k_2\right)\alpha^* - 4k_1k_3 = 0 \\
& \left[3k_1 + \left(2 + \frac{\kappa}{2}\right)k_2\right]\alpha^{**2} + \left(\frac{r\sigma^2}{b} + 2k_3 - (4k_1 + 2\kappa k_2)(k_1 + k_2)\right)\alpha^{**} - (4k_1 + 2\kappa k_2)k_3 = 0
\end{aligned}$$

or equivalently

$$(3k_1 + 2k_2)\alpha^{*2} + \left(\frac{r\sigma^2}{b} + 2k_3 - 4k_1^2 - 4k_1k_2\right)\alpha^* - 4k_1k_3 = 0 \quad (26)$$

$$\begin{aligned}
& (3k_1 + 2k_2)\alpha^{**2} + \left(\frac{r\sigma^2}{b} + 2k_3 - 4k_1^2 - 4k_1k_2\right)\alpha^{**} - 4k_1k_3 \\
& \quad + \kappa k_2 \left(\frac{\alpha^{**2}}{2} - (2k_1 + 2k_2)\alpha^{**} - 2k_3\right) = 0 \quad (27)
\end{aligned}$$



Both have a unique positive root. Equation (26) is equivalent to

$$(2k_1 + 2k_2)\alpha^{*2} + \left(\frac{r\sigma^2}{b} + 2k_3\right)\alpha^* + 2k_1\left(\frac{\alpha^{*2}}{2} - (2k_1 + 2k_2)\alpha^* - 2k_3\right) = 0$$

which means that the last term of the LHS of this equation is strictly negative. It further implies that the LHS of equation (27) would be strictly positive if it is evaluated at  $\alpha^*$  instead of  $\alpha^{**}$ . As the LHS of equation (27) is strictly negative if it is evaluated at 0 it then follows by the Intermediate Value Theorem that  $0 < \alpha^{**} < \alpha^*$ . In addition, if  $\alpha^* \geq 2k_1$ , we would have the LHS of equation (26) being positive, which yields a contradiction. Thus,  $0 < \alpha^{**} < \alpha^* < 2k_1$ .

**Theorem 1.** *If  $k_3 > -2k_1k_2$ , then the system has a solution such that  $\alpha_1 > \alpha_2 > 0$ . If in addition,  $k_3 > 2k_1^2 - k_1k_2$ , then the system has a unique solution such that  $\alpha_1, \alpha_2 > 0$ .<sup>43</sup>*

*Proof.* There are several new observations given by  $k_3 > -2k_1k_2$ .

1. Curve 1 crosses the  $\alpha_2$ -axis at  $(0, -\frac{k_3}{k_2})$  where  $-\frac{k_3}{k_2} > 2k_1$ .
  2. On Curve 1, as  $\alpha_1$  approaches  $2k_1$  from the left,  $\alpha_2 \rightarrow -\infty$ .
  3. The function represented by Curve 1 either first increases and then decreases in  $\alpha_1$  over  $(0, 2k_1)$ , or it is always decreasing in  $\alpha_1$  over  $(0, 2k_1)$ . This can be shown by taking derivatives, and is omitted here.
  4. Curve 2 crosses the  $\alpha_1$ -axis at  $(-\frac{k_3(4k_1+2\kappa k_2)}{2k_1k_2}, 0)$ , where  $-\frac{k_3(4k_1+2\kappa k_2)}{2k_1k_2} > 2k_1$ .
- (i) First, given  $k_3 > -2k_1k_2$ , we show the existence of a solution such that  $\alpha_1 > \alpha_2 > 0$ .

*Proof.* Recall that Curve 1 passes  $(\alpha^*, \alpha^*)$  where  $0 < \alpha^* < 2k_1$ . Then combined with the first three observations, it follows that the function represented by Curve 1 must be decreasing in  $\alpha_1$  over  $(\alpha^*, 2k_1)$ . Meanwhile, Curve 2 also passes  $(\alpha^{**}, \alpha^{**})$  where  $0 < \alpha^{**} < 2k_1$ . Combined with the last observation and the fact that  $\alpha_1$  is uniquely pinned down by  $\alpha_2$ , it follows that the function represented by Curve 2 must be decreasing in  $\alpha_1$  over  $(\alpha^{**}, 2k_1)$ . By the Intermediate Value Theorem, Curve 1 and 2 must intersect and the intersection satisfies  $\alpha_1 > \alpha_2$ . The result is the most clear if one draws out the curves in such a way that the  $y$ -axis is  $\alpha_2$ .

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<sup>43</sup>Note that the second condition implies the first.

- (ii) Second, given  $k_3 > 2k_1^2 - k_1k_2$ , we show that all solutions such that  $\alpha_1, \alpha_2 > 0$  must satisfy  $\alpha_1 > \alpha_2$ .

*Proof.* Consider equation (25). The RHS is negative because  $k_2 < 0$  and

$$2k_1\alpha_2 + 2k_2\alpha_2 + 2k_3 - \frac{\alpha_2^2}{2} > 4k_1^2 - 2k_1k_2 - \frac{(2k_1)^2}{2} > 0$$

At the same time, the first term in the LHS is positive because

$$3k_1(\alpha_1 + \alpha_2) + k_2\alpha_2 + 2k_3 + \frac{r\sigma^2}{b} - (4k_1 - 2k_2)k_1 > 2k_3 - (4k_1 - 2k_2)k_1 > 0$$

To balance the equation,  $\alpha_2 - \alpha_1$  has to be negative, that is, there is no solution such that  $0 < \alpha_1 < \alpha_2$ .

- (iii) Lastly, we show that there cannot be two distinct solutions such that  $\alpha_1 > \alpha_2 > 0$ .

*Proof.* Suppose, to the contrary, there are two solutions satisfying  $\alpha_1 > \alpha_2 > 0$ . Let the first solution be  $(\bar{\alpha}_1, \bar{\alpha}_2)$  and the second be  $(\underline{\alpha}_1, \underline{\alpha}_2)$ . Without loss of generality,  $\bar{\alpha}_1 > \underline{\alpha}_1$ . Since both of them need to satisfy equation (25), denote

$$F(\alpha_1, \alpha_2) = \left[ 3k_1(\alpha_1 + \alpha_2) + k_2\alpha_2 + \underbrace{2k_3 + \frac{r\sigma^2}{b} - (4k_1 - 2k_2)k_1}_{\equiv C > 0} \right] (\alpha_2 - \alpha_1) - \kappa k_2 \left( 2k_1\alpha_2 + 2k_2\alpha_2 + 2k_3 - \frac{\alpha_2^2}{2} \right)$$

In the region  $\alpha_1 > \alpha_2 > 0$ ,

$$\begin{aligned} \frac{\partial F}{\partial \alpha_1} &= -6k_1\alpha_1 - k_2\alpha_2 - C < 0 \\ \frac{\partial F}{\partial \alpha_2} &= (3k_1 + (1 + \frac{\kappa}{2})k_2) \cdot 2\alpha_2 + C - k_2\alpha_1 - 2\kappa k_2(k_1 + k_2) > 0 \end{aligned}$$

By the Implicit Function Theorem, we should have  $\bar{\alpha}_2 > \underline{\alpha}_2$ . But this is contradicting with the fact that both curves are decreasing in the region  $\alpha_1 > \alpha_2 > 0$ . Thus, the solution is unique.

Therefore, because  $\alpha_1^* > \alpha_2^* = \alpha_3^*$  it follows that the equilibrium effort of the maverick manager  $e_1^*$  is higher than that of the managers of the commonly-held firms,  $e_2^* = e_3^*$ . As a result, the marginal cost of the maverick firm  $c_1 \equiv c_L$  is lower than that of the commonly-held firms  $c_2 = c_3 \equiv c_H$ . Given these marginal costs the resulting equilibrium prices are given by

$$\begin{aligned} p_L^* &\equiv p_{1,I}^* = p_{1,II}^* = \frac{A(2b+a) + 2b^2c_L + abc_H}{4b^2 - a^2} \\ p_M^* &\equiv p_{2,II}^* = p_{3,I}^* = \frac{A(2b+a) + 2b^2c_H + abc_L}{4b^2 - a^2} \\ p_H^* &\equiv p_{2,III}^* = p_{3,III}^* = \frac{A(2b+a) + 2b^2c_H + abc_H}{4b^2 - a^2}. \end{aligned}$$

Comparing these expressions establishes that  $p_L^* < p_M^* < p_H^*$ . Furthermore, note that the maverick firm does not have a common shareholder, so Curve 1 is independent of  $\kappa$ . At the same time, Curve 2 moves monotonically with  $\kappa$ . To see this, notice that the original first order condition of Owner 2 can be expressed as

$$\underbrace{k_2(2k_1 - \alpha_2)}_{<0 \text{ as } \alpha_2 < 2k_1} \alpha_1 = G(\alpha_2) - \underbrace{\kappa k_2 \left( 2k_1\alpha_2 + 2k_2\alpha_2 + 2k_3 - \frac{\alpha_2^2}{2} \right)}_{<0 \text{ by assumption on } k_3}$$

Therefore, if we fix  $\alpha_2$ , as  $\kappa$  increase,  $\alpha_1$  must decrease in order to stay on Curve 2. In other words, in a graph where  $\alpha_1$  is the  $x$ -axis and  $\alpha_2$  is the  $y$ -axis, as  $\kappa$  increases, Curve 1 does not change, but Curve 2 moves downwards. Then it is clear that  $\alpha_1^*$  ( $\alpha_2^*$ ) increases (decreases) in  $\kappa$ , and it follows that  $\alpha_1^* - \alpha_2^*$  increases in  $\kappa$ . It follows that when  $\kappa$  increases the difference  $c_H - c_L$  increases. Therefore, the differences in prices charged by maverick and commonly-held firms between the market with common ownership (III) and the markets without common ownership (I and II) given by  $p_H^* - p_L^*$  and  $p_H^* - p_M^*$  also increase when  $\kappa$  increases.

## A.4 Strategic Substitutes

Consider the following change to our baseline model. Instead of competing in prices, firms compete in quantities. For each firm  $i$  a quantity specialist sets the optimal quantity  $q_i$ . Given the representative consumer's preferences the inverse demand function facing firm  $i$  is  $p_i(q_i, q_j) = A - bq_i - a \sum_{j \neq i} q_j$  where the parameters are now defined as  $A = \omega$ ,  $b = \rho$ , and  $a = \gamma$ .

The maximization problem for the majority owner of firm  $i$  in stage 1 is given by

$$\begin{aligned} & \max_{s_i, \alpha_i} \pi_i - w_i + \sum_{j \neq i} \kappa(\pi_j - w_j) \\ \text{subject to } & u_i \geq \bar{u} \quad \text{and} \quad e_i^* \in \arg \max_{e_i} \mathbb{E}[-\exp(-r(w_i - q_i e_i^2/2))] \quad \text{and} \quad q_i^* \in \arg \max_{q_i} \pi_i. \end{aligned}$$

Specifically, the maximization problem for the manager of firm  $i$  in stage 2 is given by

$$\max_{e_i} s_i + \alpha_i \pi_i - \frac{r}{2} \alpha_i^2 \sigma^2 - q_i e_i^2/2,$$

and that of the quantity specialist is given by

$$\max_{q_i} q_i(A - bq_i - a \sum_{j \neq i} q_j - c_i) + \varepsilon_i.$$

The resulting first-order conditions from the maximization choices in stage 2 can be rearranged to yield the following best-response functions for the manager and the quantity specialist of firm  $i$

$$\begin{aligned} e_i &= \alpha_i \\ q_i &= \frac{A - (\bar{c} - e_i) - a \sum_{j \neq i} q_j}{2b}. \end{aligned}$$

As before, these first-order conditions yield a system of  $2n$  linear equations which we solve for the equilibrium efforts  $e_i^*(\vec{\alpha})$  as well as the equilibrium quantities  $q_i^*(\vec{\alpha})$  of the  $n$  firms as a function of the vector of incentive slopes  $\vec{\alpha}$ . Substituting these equilibrium effort and quantity choices into the expression for each firm  $i$ 's profit yields the equilibrium profits  $\pi_i^*(\vec{\alpha})$  in stage 2 as a function of the vector of incentive slopes chosen in stage 1. In stage 1, the majority owner of firm  $i$  uses the salary  $s_i$  to satisfy the manager's individual rationality constraint and uses the incentive slope  $\alpha_i$  to maximize her profit shares both in firm  $i$  and all other firms  $j \neq i$  taking into account the effects of  $\alpha_i$  on the equilibrium effort and price choices in stage 2.

The resulting equilibrium quantity  $q_i^*(\vec{\alpha})$  and profit  $\pi_i^*(\vec{\alpha})$  of firm  $i$  are given by

$$q_i^*(\vec{\alpha}) = \frac{(2b-a)(A-\bar{c}) + \alpha_i[2b + (n-2)a] - a \sum_{j \neq i} \alpha_j}{(2b-a)[2b + (n-1)a]}$$

$$\pi_i^*(\vec{\alpha}) = \frac{b\{(2b-a)(A-\bar{c}) + \alpha_i[2b + (n-2)a] - a \sum_{j \neq i} \alpha_j\}^2}{(2b-a)^2[2b + (n-1)a]^2}.$$

Following the same steps as the proof of Proposition 1 establishes that  $\frac{\partial \alpha^*}{\partial \kappa} < 0$ .

The only quantitative change is that for any given  $\kappa$ , an owner's optimal choice of  $\alpha_i$  is larger than with strategic complements because of the opposite strategic effect on firm profits under strategic substitutes. When the owner of firm  $i$  lowers  $\alpha_i$  under differentiated Bertrand competition this leads to a higher price  $p_i$  which in turn results in higher  $p_j$  which benefits firm  $i$ . In contrast, lowering  $\alpha_i$  under differentiated Cournot leads to a lower quantity  $q_i$  which in turn induces higher  $q_j$  which hurts firm  $j$ .

## B Additional Empirical Results

**Table B1.** Panel A. Wealth-performance sensitivity as a function of different measures of common ownership (Compustat).

This table presents the association between different common ownership measures and the [Edmans et al. \(2009\)](#) measure of wealth performance sensitivity (EGL) using four-digit Compustat industry definitions.

Dependent Variable	ln(Wealth-performance Sensitivity EGL)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
CO (Kappa)	-0.114*** (0.038)						
CO (Cosine Similarity)		-0.304*** (0.049)					
CO (Top 5 Overlap)			-0.208*** (0.039)				
CO (Anton and Polk)				-0.451*** (0.090)			
CO (Harford, Jenter and Li)					-0.455*** (0.090)		
CO (MHHID)						-0.0263 (0.083)	
CO (MHHID 1/N)							0.00390 (0.059)
Volatility	1.023*** (0.290)	0.981*** (0.288)	1.035*** (0.286)	0.924*** (0.285)	0.943*** (0.286)	1.007*** (0.288)	1.005*** (0.288)
ln(Market Equity)	0.343*** (0.019)	0.349*** (0.019)	0.345*** (0.019)	0.356*** (0.020)	0.357*** (0.020)	0.338*** (0.019)	0.338*** (0.019)
Leverage	0.0141 (0.061)	0.00813 (0.060)	0.0114 (0.060)	0.00360 (0.051)	0.00209 (0.059)	0.0159 (0.057)	0.0163 (0.060)
HHI	-0.0158 (0.059)	-0.0169 (0.056)	-0.0147 (0.067)	-0.0437 (0.083)	-0.0452 (0.080)	-0.0164 (0.063)	-0.00731 (0.001)
ln(Tenure)	0.479*** (0.029)	0.485*** (0.028)	0.483*** (0.028)	0.485*** (0.028)	0.486*** (0.028)	0.478*** (0.029)	0.478*** (0.029)
Observations	45,670	45,670	45,393	45,670	45,670	45,676	45,676
R-squared	0.687	0.688	0.688	0.688	0.688	0.687	0.687
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes

**Table B1.** Panel B. Wealth-performance sensitivity as a function of different measures of common ownership (Hoberg-Phillips).

This table presents the association between different common ownership measures and the [Edmans et al. \(2009\)](#) measure of wealth performance sensitivity (EGL) using four-digit Hoberg-Phillips industry definitions.

Dependent Variable	ln(Wealth-performance Sensitivity EGL)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
CO (Kappa)	-0.101** (0.042)						
CO (Cosine Similarity)		-0.204*** (0.043)					
CO (Top 5 Overlap)			-0.152*** (0.037)				
CO (Anton and Polk)				-0.372*** (0.087)			
CO (Harford, Jenter and Li)					-0.350*** (0.082)		
CO (MHHID)						-0.169** (0.080)	
CO (MHHID 1/N)							-0.0315 (0.053)
Volatility	1.050*** (0.272)	1.003*** (0.272)	1.007*** (0.273)	0.963*** (0.270)	0.978*** (0.272)	1.034*** (0.271)	1.036*** (0.272)
ln(Market Equity)	0.368*** (0.023)	0.372*** (0.023)	0.366*** (0.023)	0.381*** (0.024)	0.380*** (0.024)	0.364*** (0.024)	0.364*** (0.024)
Leverage	0.0332 (0.072)	0.0285 (0.071)	0.0260 (0.073)	0.0281 (0.073)	0.0275 (0.072)	0.0356 (0.071)	0.0360 (0.073)
HHI	0.0116 (0.054)	0.00405 (0.057)	0.0131 (0.055)	-0.0169 (0.036)	-0.0178 (0.033)	-0.0563 (0.061)	0.0171 (0.057)
ln(Tenure)	0.493*** (0.035)	0.496*** (0.035)	0.495*** (0.035)	0.497*** (0.034)	0.497*** (0.034)	0.492*** (0.035)	0.492*** (0.035)
Observations	34,161	34,161	33,959	34,161	34,161	34,172	34,172
R-squared	0.698	0.698	0.697	0.698	0.698	0.698	0.698
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes

**Table B2.** Panel A. Wealth-performance sensitivities as a function of common ownership: alternative WPS measures (Compustat).

This table presents coefficient estimates from regressions of different measures of wealth-performance sensitivity on common ownership. The difference to Table 7 is that we use four-digit Compustat industry definitions. In columns (1) to (3) the dependent variable is the [Jensen and Murphy \(1990\)](#) measure (JM) while in columns (4) to (6) it is the [Hall and Lieberman \(1998\)](#) measure (HL).

Dependent Variable	ln(WPS JM)			ln(WPS HL)		
	(1)	(2)	(3)	(4)	(5)	(6)
CO (Kappa)	-0.136*** (0.038)			-0.0910** (0.043)		
CO (Cosine Similarity)		-0.248*** (0.043)			-0.176*** (0.048)	
CO (Top 5 Overlap)			-0.192*** (0.033)			-0.135*** (0.036)
Volatility	1.260*** (0.281)	1.218*** (0.280)	1.271*** (0.282)	1.456*** (0.301)	1.427*** (0.299)	1.472*** (0.297)
ln(Market Equity)	0.0782*** (0.023)	0.0818*** (0.022)	0.0784*** (0.022)	0.681*** (0.021)	0.684*** (0.021)	0.681*** (0.021)
Leverage	-0.553*** (0.060)	-0.557*** (0.059)	-0.552*** (0.060)	0.0672 (0.061)	0.0642 (0.061)	0.0673 (0.062)
HHI	-0.0744 (0.079)	-0.0729 (0.080)	-0.0789 (0.075)	-0.0386 (0.067)	-0.0379 (0.068)	-0.0426 (0.082)
ln(Tenure)	0.386*** (0.025)	0.390*** (0.025)	0.391*** (0.025)	0.560*** (0.032)	0.563*** (0.032)	0.563*** (0.032)
Observations	45,670	45,670	45,393	45,670	45,670	45,393
R-squared	0.793	0.794	0.794	0.793	0.793	0.793
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes



**Table B2.** Panel B. Wealth-performance sensitivities as a function of common ownership: alternative WPS measures (Hoberg-Phillips).

This table presents coefficient estimates from regressions of different measures of wealth-performance sensitivity on common ownership. The difference to Table 7 is that we use four-digit Hoberg-Phillips industry definitions. In columns (1) to (3) the dependent variable is the [Jensen and Murphy \(1990\)](#) measure (JM) while in columns (4) to (6) it is the [Hall and Liebman \(1998\)](#) measure (HL).

Dependent Variable	ln(WPS JM)			ln(WPS HL)		
	(1)	(2)	(3)	(4)	(5)	(6)
CO (Kappa)	-0.106** (0.042)			-0.0511 (0.044)		
CO (Cosine Similarity)		-0.165*** (0.041)			-0.0930** (0.042)	
CO (Top 5 Overlap)			-0.166*** (0.033)			-0.105*** (0.034)
Volatility	1.453*** (0.276)	1.412*** (0.277)	1.420*** (0.279)	1.475*** (0.274)	1.453*** (0.273)	1.457*** (0.274)
ln(Market Equity)	0.115*** (0.031)	0.118*** (0.030)	0.115*** (0.030)	0.722*** (0.023)	0.724*** (0.023)	0.722*** (0.023)
Leverage	-0.556*** (0.062)	-0.559*** (0.062)	-0.563*** (0.062)	0.0928 (0.063)	0.0908 (0.063)	0.0865 (0.061)
HHI	-0.0153 (0.040)	-0.0189 (0.032)	-0.0158 (0.038)	0.0188 (0.051)	0.0159 (0.051)	0.0204 (0.051)
ln(Tenure)	0.394*** (0.028)	0.396*** (0.028)	0.397*** (0.028)	0.538*** (0.031)	0.540*** (0.030)	0.541*** (0.030)
Observations	34,161	34,161	33,959	34,161	34,161	33,959
R-squared	0.803	0.803	0.803	0.814	0.814	0.814
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes

**Table B3.** Wealth-performance sensitivity as a function of common ownership: horse race between kappa components (cosine similarity and IHHI ratio).

This table presents regressions similar to those in Table 5 and Table 6. The outcome variable is again the [Edmans et al. \(2009\)](#) measure of wealth performance sensitivity (EGL). Column (1) repeats the specification of column (1) of Table 5 using the rank-transformed measure of kappa. The remaining columns (2) to (5) take logs of each  $\kappa_{ij}$  to decompose it into its two subcomponents and then average it across all industry competitors.

Dependent Variable	ln(Wealth-performance Sensitivity EGL)				
	(1)	(2)	(3)	(4)	(5)
$\bar{\kappa}_i$	-0.133*** (0.045)				
$\overline{\log(\kappa_{ij})}$		-0.0270** (0.011)			
$\overline{\log(\cos_{ij})}$			-0.0752*** (0.014)		-0.0811*** (0.014)
$\overline{\log \sqrt{\frac{IHHI_j}{IHHI_i}}}$				0.0172 (0.014)	0.0336** (0.015)
Volatility	-0.113 (0.072)	0.343*** (0.019)	0.347*** (0.019)	0.340*** (0.020)	0.348*** (0.019)
ln(Market Equity)	0.346*** (0.019)	1.357*** (0.280)	1.326*** (0.277)	1.350*** (0.280)	1.311*** (0.276)
Leverage	1.363*** (0.278)	0.0367 (0.064)	0.0321 (0.065)	0.0378 (0.064)	0.0309 (0.063)
HHI	0.0377 (0.064)	-0.125 (0.088)	-0.128 (0.085)	-0.112 (0.090)	-0.123 (0.088)
ln(Tenure)	0.487*** (0.030)	0.486*** (0.030)	0.489*** (0.030)	0.484*** (0.030)	0.489*** (0.029)
Observations	42,788	42,706	42,706	42,706	42,706
R-squared	0.682	0.682	0.682	0.682	0.682
Firm FE	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes

**Table B4.** Wealth-performance sensitivity as a function of common ownership: robustness to using lagged common ownership measures.

This table presents coefficients from regressions of wealth-performance sensitivities on common ownership. The difference to Table 6 and Table B1 is that we use lagged common ownership measures instead of the contemporaneous measures.

Dependent Variable	ln(Wealth-performance Sensitivity EGL)								
Industry Definition	SIC CRSP			SIC COMP			HOBERG-PHILLIPS		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Lag of CO (Kappa)	-0.105** (0.039)			-0.103** (0.039)			-0.147*** (0.038)		
Lag of CO (Cosine Similarity)		-0.236*** (0.040)			-0.255*** (0.039)			-0.216*** (0.037)	
Lag of CO (Top 5 Overlap)			-0.173*** (0.034)			-0.168*** (0.029)			-0.177*** (0.031)
Volatility	-0.0903* (0.051)	-0.104* (0.049)	-0.114** (0.049)	-0.0385 (0.039)	-0.0466 (0.043)	-0.0437 (0.047)	-0.0774 (0.043)	-0.0848* (0.045)	-0.0955* (0.045)
ln(Market Equity)	0.344*** (0.020)	0.348*** (0.020)	0.349*** (0.021)	0.343*** (0.020)	0.347*** (0.020)	0.344*** (0.020)	0.387*** (0.023)	0.389*** (0.023)	0.385*** (0.023)
Leverage	1.297*** (0.285)	1.229*** (0.284)	1.292*** (0.295)	1.313*** (0.285)	1.266*** (0.284)	1.316*** (0.291)	1.329*** (0.300)	1.267*** (0.299)	1.272*** (0.298)
HHI	0.0202 (0.062)	0.0191 (0.061)	0.0401 (0.062)	0.00669 (0.056)	0.00519 (0.060)	0.0101 (0.062)	0.00352 (0.064)	0.00254 (0.059)	0.00012 (0.001)
ln(Tenure)	0.532*** (0.028)	0.535*** (0.028)	0.536*** (0.028)	0.537*** (0.028)	0.541*** (0.027)	0.539*** (0.027)	0.546*** (0.034)	0.548*** (0.034)	0.548*** (0.033)
Observations	39,077	39,077	37,976	41,810	41,810	41,318	30,886	30,886	30,538
R-squared	0.663	0.663	0.663	0.659	0.660	0.661	0.678	0.678	0.678
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

**Table B5.** Wealth-performance sensitivity as a function of common ownership: robustness to coarser industry definitions at the three-digit level.

This table presents regressions similar to those in Table 6 and Table B1 but uses coarser three-digit industry definitions. The outcome variable is the [Edmans et al. \(2009\)](#) measure of wealth-performance sensitivity (EGL).

Dependent Variable	ln(Wealth-performance Sensitivity EGL)								
Industry Definition	SIC CRSP			SIC COMP			HOBERG-PHILLIPS		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
CO (Kappa)	-0.0878** (0.042)			-0.0652 (0.042)			-0.105** (0.039)		
CO (Cosine Similarity)		-0.233*** (0.044)			-0.248*** (0.044)			-0.207*** (0.041)	
CO (Top 5 Overlap)			-0.145*** (0.034)			-0.169*** (0.035)			-0.134*** (0.035)
Volatility	1.354*** (0.265)	1.321*** (0.266)	1.310*** (0.262)	1.276*** (0.277)	1.247*** (0.274)	1.226*** (0.275)	1.150*** (0.275)	1.106*** (0.272)	1.100*** (0.271)
ln(Market Equity)	0.344*** (0.020)	0.349*** (0.020)	0.345*** (0.020)	0.340*** (0.020)	0.347*** (0.020)	0.342*** (0.020)	0.378*** (0.023)	0.382*** (0.022)	0.377*** (0.023)
Leverage	0.0137 (0.057)	0.00804 (0.059)	0.0261 (0.058)	-0.00653 (0.001)	-0.0136 (0.045)	0.00331 (0.056)	0.0142 (0.069)	0.0099 (0.064)	0.0151 (0.069)
HHI	-0.0290 (0.037)	-0.0442 (0.049)	-0.0366 (0.044)	-0.0839 (0.082)	-0.104 (0.083)	-0.0997 (0.079)	-0.0261 (0.036)	-0.0347 (0.041)	-0.0290 (0.034)
ln(Tenure)	0.479*** (0.030)	0.483*** (0.030)	0.480*** (0.029)	0.476*** (0.030)	0.481*** (0.029)	0.476*** (0.029)	0.489*** (0.034)	0.492*** (0.034)	0.492*** (0.034)
Observations	46,483	46,483	46,254	46,808	46,808	46,692	34,953	34,953	34,853
R-squared	0.648	0.648	0.648	0.647	0.648	0.648	0.672	0.672	0.672
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry (SIC-2) $\times$ Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

**Table B6.** Change in common ownership (cosine similarity) following index addition of a competitor.

This table presents the effect of the Treat variable on firm-level common ownership of index incumbents. The outcome variable is the average cosine similarity.

Dependent Variable	Change in Common Ownership (Cosine Similarity)					
Industry Definition	SIC CRSP		SIC COMP		HOBERG-PHILLIPS	
	(1)	(2)	(3)	(4)	(5)	(6)
Treat	0.00878*** (0.002)	0.0134*** (0.003)	0.00679*** (0.001)	0.00944*** (0.002)	0.00463*** (0.002)	0.00666*** (0.002)
Observations	101,835	101,827	114,189	114,179	73,743	73,727
R-squared	0.000	0.109	0.000	0.125	0.000	0.142
Firm FE	No	Yes	No	Yes	No	Yes
Year FE	No	Yes	No	Yes	No	Yes