Economic Downsides and Antitrust Liability Risks from Horizontal Shareholding

Posted by Einer Elhauge, Harvard Law School, on Tuesday, January 12, 2016

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Editor's Note: Einer Elhauge is the Petrie Professor of Law at Harvard Law School. This post is based on Professor Elhauge's recent **article**, forthcoming in the *Harvard Law Review*.

In recent decades, institutional investors have grown and become more active in influencing corporate management. While this development has often been viewed as salutary from a corporate governance perspective, the implications for product market competition have become deeply troubling. As I show in a new article called **Horizontal Shareholding** (forthcoming in the *Harvard Law Review*), this growth in institutional investors means that a small group of institutions has acquired large shareholdings in horizontal competitors throughout our economy, causing them to compete less vigorously with each other.

For example, seven shareholders who controlled 60% of United Airlines also controlled big chunks of United's major rivals, including 27.5% of Delta Airlines, 22.3% of Southwest Airlines, and 20.7% of JetBlue Airlines. More generally, institutional investors held 77% of the stock of all airlines operating in the average route. **A new econometric study** shows that this sort of horizontal shareholding has made average airline prices 3-10% higher than they otherwise would have been.

The airline industry is not the only industry plagued by such horizontal shareholdings. In the banking industry, the top four shareholders of JP Morgan Chase (BlackRock, Vanguard, Fidelity, and State Street) were also the top four shareholders of Bank of America and four of the top six shareholders of Citigroup, collectively holding 19.2% of JP Morgan Chase, 16.9% of Bank of America, and 21.9% of Citigroup. **Another new econometric study** finds that such horizontal shareholdings have significantly increased the fees that banks charge and decreased the deposit rates that banks pay.

Likewise, these institutional investors had leading horizontal shareholdings at Apple and Microsoft and at CVS and Walgreens. Indeed, there is every reason to think that the problem of horizontal shareholding is pervasive across our economy because institutional investors like BlackRock, Vanguard, Fidelity, and State Street now own around 80% of all stock in S&P 500 corporations.

Economic theory has long shown that horizontal shareholdings like these reduce the incentives of horizontal competitors to compete with each other. This is easiest to see when the owners of a firm are identical to the owners of that firm's rival. In that case, a firm has no incentive to undercut its rival's price to take away a sale because the movement of the sale to the firm from the rival simply moves money from one of their owners' pockets to another. The net effect for those owners of cutting prices would be that the prices charged by both firms are lower, thus lowering those owners' profits across both firms.

This anticompetitive incentive is similar, though somewhat attenuated, when the shareholders of two firms are only partially overlapping. Suppose one firm's shareholders also own 50% of that firm's rival. Now, the firm's shareholders will gain some profits by moving a sale from the rival to the firm, but less profits than if their shareholders were entirely different. Instead, a firm acting on behalf of its shareholders will realize that each sale gained by the firm costs the firm's owners not only the usual marginal cost of making the product, but also 50% of the profits those shareholders lose from having the sale taken away from the rival. The effect on firm pricing incentives is the same as if its marginal cost for expanding output were increased by an amount equal to half the profits the rival loses by losing a sale. Like any increase in a firm's marginal costs, this effect reduces the incentives of each firm to price products lower even if their respective managers never communicate or coordinate with each other.

Evidence indicates that institutional investors usually communicate with and actively seek to influence the corporations in which they own shares, which exacerbates the anticompetitive effects of horizontal shareholdings. However, investor-manager communications are not necessary for horizontal shareholdings to have anticompetitive effects. Without any active communication, corporate managers know the identity of their shareholders and the fact that their shareholders also own shares in their rivals. Managers also have incentives to take those shareholder interests into account for a variety of reasons, including: out of a sense of fiduciary duty or gratitude, to gain support in future elections, to enhance future job prospects, because executive compensation methods align with shareholder interests, or so their shareholders will help fend off takeover threats. None of those reasons requires any management- shareholder communication.

Such horizontal shareholdings can help explain some fundamental economic puzzles. Of particular interest to those interested in corporate governance, I show that horizontal shareholdings help explain the puzzle of why large, sophisticated corporate shareholders support executive compensation methods that reward executives for the success of their industry rather than the relative success of their firm alone. My colleagues Professors Lucian Bebchuk and Jesse Fried have persuasively shown that the prevailing method of executive compensation does not maximize profits for the individual firm. But given horizontal shareholdings, institutional investors do not want to maximize profits at the individual firm. They instead want to maximize profits across all the firms in that market in which they are invested. Rewarding managers for industry performance thus serves well the financial interest of horizontal shareholders.

Horizontal shareholdings also help explain why, in the recovery from the recent Great Recession, firms that made record-high profits because of enormous fiscal and monetary stimuli have proven so reluctant to invest those high profits on increasing output and employment. Finally, the rise of horizontal shareholdings in recent decades helps explain why, as Thomas Piketty has famously observed, income inequality has risen in those recent decades.

Contrary to the assertion by some that new legislation is required to deal with this new anticompetitive problem, current antitrust law provides ample authority for antitrust agencies and private litigants to attack stock acquisitions that create anticompetitive horizontal shareholdings in concentrated markets. The so-called passive-investor exception is not a bar. That exception requires complete passivity in influencing corporate management or governance, not a passive investment strategy like indexing to pick investments. Nor is it really an exception because, when established, all the doctrine really does is heighten the burden of proof. Because the empirical evidence suggests this heightened burden can be met, even truly passive horizontal shareholdings could be subject to antitrust challenge.

Institutional investors should thus consider seriously the fact that their horizontal shareholdings in concentrated product markets make them vulnerable to a risk of antitrust liability and damages whenever it can be shown that those horizontal shareholdings likely produced an increase in product prices. This risk may be hardest to address for index funds and ETFs that are growing fast and are currently committed to invest across all majors firms in an industry. But to avoid antitrust problems, index funds and ETFs must at some point either stop growing, give up any voting influence, or become indexed across industries rather than indexed across all competitors in each industry.

The full article is available for download **here**.
