Horizontal Shareholding and the EU Competition Law

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I. Defining the terms and the problem

So-called ***"horizontal shareholding"*** (HS) is the participation of common shareholders in the capital of competing companies, in particular as institutional investors. HS is often used as a synonym to ***"common shareholding"***.

Economic studies on the US airline industry and banking sector found that the participation HS in the leading companies on highly concentrated markets may create ***incentives to lessen competition and raise prices***.

Although vigorously disputed the findings of the studies have been confirmed by new sectoral studies showing that HS may indeed result in restrictions of competition.

II. The growing importance of institutional ownership and passive investment strategies

- The percentage of all publicly listed stocks in the US held by physical persons decreased from 84% in the mid 1960s to ca. 40% in the first years of 2010s.
- Between 2011 and 2014 passive investment funds (in particular index funds and ETFs) doubled their Assets under Management (AuM).
- At the end of 2015 these funds had at least 4 trillion USD under management.
- In June 2016 the "Big Three" (BlackRock, Vanguard, State Street) managed more than 90% of all AuM in passive equity funds.

III. Anticompetitive effects of horizontal shareholding – the Causal Mechanisms

Despite their minority shareholding, institutional investors are in a position to influence the managers and consequently the behavior of the portfolio companies, mainly through

1. Voting in the elections for the BoD: Managers maximize the weighted average of their shareholders' profits from all their shareholdings by increasing prices, in order to maximize their re-election chances.

2. Direct communication with management of portfolio companies: Evidence that such communication (with price increases as their central topic) is quite common and preferred to formal shareholder meetings.

3. Executive compensation: Tying executive compensation to the performance of the market instead of the performance of their firm aligns the manager's interests with those of horizontal shareholders.

IV. The rebuttal – Index funds as a powerful force for the *"democratization of investment"*

Index funds submit that they provide protection against overexposure to the risk of individual stock at low costs, thus contributing to the democratization of investment. They also argue that

- Direct communication with managers does not weaken competition between portfolio companies,
- Managers do not act as specifically activist or passive shareholders but usually take a middle approach,
- Executive compensation schemes are unlikely to affect competition - more research needed on the factors determining executive compensation,
- Higher prices may increase stock value of portfolio companies (PC) in one market but also reduce consumer spending in others, thus reducing stock value of companies which are also in the asset managers' portfolios.

V. Horizontal shareholding under US Antitrust Law

Most discussed proposals for dealing with horizontal shareholdings (HS):

- ***Elhauge*** takes the view that HS may be illegal under sec. 7 Clayton Act which bans stock acquisitions resulting in HS with anticompetitive effects but also under sec. 1 Sherman Act which is applicable to contracts between HS and portfolio firms incentivizing the latter to lessen competition.

- ***Rock/Rubinfeld*** advocate guidelines for diversified shareholders which would provide for a merger control safe harbor for investors holding <15% of a company's shares without a representative on the BoD and without engagement or beyond the normal engagement in corporate governance

- ***Posner/Scott Morton/Weyl*** submit that investors with a diversified portfolio may not hold more than a 1% share of an oligopolistic market unless it is a free-standing index fund that commits to being purely passive. Alternatively, institutional investors may invest in single competitors without restrictions.

VI. Dealing with HS under EU Competition Law –

Is the available legal framework adequate?

1. The EU Merger Regulation 139/2004 requires the acquisition of sole or joint control over the PC. However,

- a series of acquisitions by institutional investors allowing a set of horizontal shareholders to collectively exercise decisive influence over target companies cannot qualify as joint control without stable coalitions or extensive links between minority shareholders

- under the current merger control status, a passive strategy of institutional investors cannot establish control over PCs

- the fact that institutional investors are shareholders of companies active in oligopolistic markets does not make those companies collectively dominant. Common shareholders are usually the only link between them and the requirements of the *Airtours* and *IMPALA* judgments are not met.

2. Is Article 101 TFEU applicable to HS?

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- the restriction of competition arises from the acquisition of shares of the portfolio companies on the market. Since a meeting of minds and, therefore, an agreement between buyer and seller of the shares cannot be established, Art. 101 TFEU does not apply.

- moreover, capturing anticompetitive effects caused by HS as concerted practices is almost as difficult as capturing as concerted practice parallel behavior attributable to an oligopolistic market structure. Lack of communication cannot be replaced by the indirect link of common shareholding which influences the portfolio firms' competitive behavior.

3. Abusive acquisition of minor shareholdings and abusive excessive pricing

- The acquisition of HS by institutional investors is unlikely to violate Art. 102 TFEU, since those investors usually have no dominant position and in addition their position will not be strengthened through a minority shareholding in a company active on a different market.
- Prices charged by the PC cannot be considered abusive just because they are the result of horizontal shareholding. Price increases of 5%, as recorded in the airline industry can be hardly held excessive under Art. 102 TFEU

►In any event HS is a structural problem which cannot be tackled with behavioral rules, i.e. Articles 101 & 102 TFEU, since they neither prevent nor eliminate the causes of anticompetitive effects.

VII. To proceed with a new legal framework for HS or to wait for more reliable evidence on its anticompetitive effects?

HS has not attracted the interest of the antitrust authorities in the US.

EU Commission: in merger cases *Dow/DuPont* and *Bayer/Monsanto* held that common shareholdings should be taken as a contextual element in the appreciation of any significant impediment of competition

► Is this reaction sufficient for what a leading scholar (*Elhauge*) views as "the greatest anticompetitive thread of our time"?

The prevailing view advocates more research on the causal link between HS and restrictions of competition before taking measures to tackle it

► Is it realistic to expect convergence of the different theoretical views on the interpretation of empirical evidence?

► Does the difference of views in economic and legal theory excuse the passivity of competition authorities and legislators ?

VIII. Two possible ways to deal with HS

1. Widening the scope of application of the EU Merger Regulation

This approach would focus on highly concentrated markets and provide for the introduction of a duty to notify acquisitions of more than 5% in leading companies.

The EU Commission would gain insight into tight oligopolies without imposing substantial burdens to institutional investors and could intervene against certain acquisitions likely to lessen competition.

The assessment on a case by case basis would take into account the particularities of each horizontal shareholding but

such a control would quite often remain theoretical mainly due to the difficulty to establish a causal link between horizontal shareholding and the restriction of competition.

2. A more drastic intervention - A dilemma between protection of competition and freedom to chose among different investments?

Introduction of a generally applicable rule related to the composition of the products offered by the institutional investors in the EU.

► It could e.g. provide that no mutual fund shares could be traded in the EU if those funds invested in more than one company active on highly concentrated markets as predefined by the Commission (see *Posner, et al*).

Where the oligopoly consists of a group of leading companies and some smaller ones, the trading restrictions concern only the former.

● Such a rule would tackle a restriction of competition which does not constitute an infringement of EU competition law – Case of regulation in place of competition similar to the EU Roaming Regulation (RR).

The requirements for the regulatory measures

Dealing with the question, whether the RR infringed the principles of proportionality and subsidiarity in its *Vodafone* judgment (C-58/08) the CJEU attached special importance to the fact that the Commission carried out an exhaustive market study before drafting the Regulation and that it examined various options and their economic impact.

CJEU: intervention protecting consumers against excessive prices, even if it might have negative economic consequences for certain operators, is proportionate in the aim pursued.

►In the case of regulatory measures against HS require balancing the benefits expected against the harm on certain categories of undertakings and/or consumers, in particular on investors.

Protection of competition v. freedom of investors to choose?

● Question concerning a limited number of markets and among them only those where institutional investors hold shares in more than one competitor

● Risk reducing diversification can be achieved by investing in shares of companies active in different markets

● Are legislators and competition authorities justified in overlooking the anticompetitive effects of HS because of their positive impact on certain undertakings and investors?

● The fall in equity prices would be more than compensated for by increases in consumer surplus, and increases total welfare" (*Schmalz,* 2018).

IX. Conclusion

► A cautious – rather than ambitious – attempt to deal with HS not as the greatest anticompetitive threat of our time but as a risk of variable degree for the functioning of certain highly concentrated markets is not very likely to cause *false positives* and thus to harm investors, institutional entities or natural persons.

► This would hold true even if the risks the adopted measures seek to tackle do not turn out to be as serious as anticipated.