

# Common-Ownership Concentration and Corporate Conduct

*Martin C. Schmalz*

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Poschingerstr. 5, 81679 Munich, Germany

Telephone +49 (0)89 2180-2740, Telefax +49 (0)89 2180-17845, email [office@cesifo.de](mailto:office@cesifo.de)

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# Common-Ownership Concentration and Corporate Conduct

## Abstract

The question of whether and how partial common-ownership links between strategically interacting firms affect firm objectives and behavior has been the subject of theoretical inquiry for decades. Since then, the growth of intermediated asset management and consolidation in the asset-management sector has led to more pronounced common ownership links at the beneficial-owner level. Recent empirical research has provided evidence consistent with the literature's prediction that common ownership concentration (CoOCo) can affect product market outcomes. The resulting antitrust concerns have received worldwide attention. However, because CoOCo can change the objective function of the firm, the potential implications span all fields of economics that involve corporate conduct, including corporate governance, strategy, industrial organization, and financial economics. This article connects the papers establishing the theoretical foundations, reviews the empirical and legal literatures, and discusses challenges and opportunities for future research.

Keywords: ownership, control, network, industry concentration, antitrust, objective of the firm, shareholder unanimity.

*Martin Schmalz*  
*Stephen Ross School of Business*  
*University of Michigan*  
*Ann Arbor / MI / USA*  
*[schmalz@umich.edu](mailto:schmalz@umich.edu)*

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## 1. INTRODUCTION

A long literature examines how ownership structure affects firm objectives, behavior and equilibrium outcomes. In particular, the ubiquitous assumption that self-interested, entrepreneurial firms seek to maximize their own value is at the core of the notion that competition maximizes social welfare. The assumption goes back at least to Smith (1776), but remains central to most research in corporate finance and industrial organization to this day.

This assumption is intuitive if one considers the ownership structures of classic entrepreneurial firms such as those reported in **Table 1**. Until recently, Richard Branson was the largest shareholder of Virgin America, Warren Buffett controls Berkshire Hathaway, Jeff Bezos is by far the largest shareholder of Amazon, and the Walton family controls Walmart. If these firms act in their largest shareholders' financial interest, they should indeed maximize their own value – and disregard the impact their actions may have on other firms' bottom lines. The basis for this intuition is that the largest shareholders don't also have significant holdings in other firms, and that holdings in other firms by diversified minority shareholders (e.g., BlackRock and Vanguard) have no significant influence on corporate strategy.

However, most US corporations' present-day ownership structure looks quite different

Table 1: “Entrepreneurial” firms.

This table shows the largest institutional and non-institutional beneficial owners and corresponding stakes for some US firms as of 2017Q2 unless otherwise noted. The data source is *S&P Capital IQ*.

<i>Virgin America (2016 Q2)</i>	<i>[%]</i>	<i>Berkshire Hathaway</i>	<i>[%]</i>
- Richard Branson -	30.99	- Warren Buffett -	17.94
Cyrus Capital Partners	23.69	Vanguard	5.05
Vanguard	2.91	BlackRock	4.15
BlackRock	2.27	State Street	3.33
Alpine Associates Advisors	2.12	Bill & Melinda Gates Foundation	2.67
Hutchin Hill Capital	2.10	Fidelity	2.36
Societe Generale	1.85	Optinova Asset Mgt.	2.23
<i>Amazon</i>	<i>[%]</i>	<i>Walmart</i>	<i>[%]</i>
- Jeffrey Bezos -	16.72	Walton Enterprises	46.97
Vanguard	5.62	Walton Family	3.78
Capital Research	5.47	Vanguard	3.51
BlackRock	5.01	BlackRock	2.97
Fidelity	3.82	State Street	2.38
T. Rowe Price	3.67	Dodge & Cox	0.70
State Street	3.40	Northern Trust	0.59

from the above examples. The various panels of **Table 2** show the top shareholders<sup>1</sup> of the largest US airlines, banks, and a selection of supermarkets, respectively. Strikingly, the top shareholders across the major players in all of these industries are very similar. Berkshire Hathaway is not only the largest shareholder of two of the nation’s largest four banks (and the third-largest shareholder in a sixth bank), but also of three of the largest four airlines (and the third-largest shareholder in the fourth). PRIMECAP holds similarly sized stakes in *each* of the largest six airlines. The mutual fund families BlackRock, Vanguard, State Street, Fidelity, and T. Rowe Price are among the major holders of most of the largest airlines as well.<sup>2</sup> Indeed, almost any one of the top shareholders of any one of the largest airlines is also a shareholder in other major carriers. Whereas each one shareholder typically holds less than 15% in a given carrier, the top-10 shareholders as a group hold between 39% and 55% of the stock in each carrier.

Perhaps even more strikingly, among United’s top 100 investors, which hold more than 91% of outstanding shares, only *five* don’t also hold stock of another top-4 airline; the largest of these shareholders ranks as #42. Cumulatively, these “mavericks” hold 1% of United’s stock, and are thus presumably powerless, even as a group. American Airlines has seven such shareholders, who hold a total of 1.4% of the stock. (Four of them are

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<sup>1</sup>To clarify terminology, I use the label “shareholder” to refer to any beneficial owner of shares and discuss the exercise of control at the level control is de facto exercised, irrespective of whether the beneficial owner is the ultimate investor (such as a household), an institutional asset manager (who holds shares on behalf of an ultimate investor), or an institution that is an ultimate investor itself (such as a sovereign wealth fund). In each case, the assumption is that the beneficial owner maximizes its own economic interest; I discuss consequences of as well as deviations from that assumption later.

<sup>2</sup>For the purposes of this introduction, I label both individual and institutional investors as “shareholders” and show beneficial ownership aggregated to the fund family level. The following sections detail the reasons behind this choice, including the distinct between beneficial and ultimate ownership, and between de facto and de jure control. The literature thus far models the economic incentives as those arising from beneficial ownership at the level de facto control is exercised.

Table 2: Panel A: Airlines.

This table shows the largest institutional and non-institutional beneficial owners and corresponding stakes for America’s largest airlines as of 2017Q2. The data source is *S&P Capital IQ*.

<i>Delta Air Lines</i>	[%]	<i>Southwest Airlines Co.</i>	[%]	<i>American Airlines</i>	[%]
Berkshire Hathaway	7.25	Berkshire Hathaway	15.03	T. Rowe Price	12.89
Vanguard	6.13	PRIMECAP	11.87	PRIMECAP	10.46
BlackRock	5.84	Vanguard	6.28	Berkshire Hathaway	9.54
Lansdowne Partners Limited	3.90	Fidelity	5.41	Vanguard	6.15
PRIMECAP	3.75	BlackRock	5.04	BlackRock	5.20
State Street Global Advisers	3.68	State Street Global Advisers	3.69	Fidelity	3.71
J.P. Morgan Asset Mgt.	3.48	Columbia Mgt. Inv. Adv.	1.46	State Street Global Advisers	3.58
Evercore	2.09	J.P. Morgan Asset Mgt.	1.29	Geode Capital Mgt.	1.03
PAR Capital Mgt.	1.78	Egerton Capital (UK) LLP	1.26	Morgan Stanley	1.00
BNY Mellon Asset Mgt.	1.24	T. Rowe Price	1.16	Northern Trust Global Inv	0.97
<i>United Continental Holdings</i>	[%]	<i>Alaska Air</i>	[%]	<i>JetBlue Airways</i>	[%]
Berkshire Hathaway	9.11	Vanguard	9.57	Vanguard	8.14
Vanguard	7.33	T. Rowe Price	9.26	BlackRock	8.04
PRIMECAP	7.19	BlackRock	5.48	PRIMECAP	6.13
BlackRock	6.72	PRIMECAP	4.89	Fidelity	5.71
PAR Capital Mgt.	5.26	State Street Global Advisers	3.55	Dimensional Fund Advisors	3.31
T. Rowe Price	3.37	Franklin Resources	2.71	Goldman Sachs Asset Mgt.	2.95
Altimeter Capital Mgt.	3.33	Egerton Capital (UK) LLP	2.39	State Street Global Advisers	2.49
State Street Global Advisers	3.33	PAR Capital Mgt.	2.02	Wellington	2.45
J.P. Morgan Asset Mgt.	2.98	Wellington	1.98	Donald Smith Co.	1.84
Henderson Global Investors	2.25	BNY Mellon Asset Mgt.	1.77	AQR Capital Management	1.73

individuals whose private portfolios cannot be observed, and who might thus in fact hold non-reportable competitor stock.) Delta has five such mavericks in the top 100, holding 6.8% of the stock, and SWA has nine, who hold a cumulative 2.7% of the outstanding stock. Ownership patterns in many other industries look similar.<sup>3</sup>

The scope of the phenomenon extends beyond the U.S. – CoOCo is an international and fast-rising trend. For example, based on Capital IQ data, with more than \$6 trn assets under management, BlackRock is not only the most powerful investor of a large and increasing fraction of US corporations, but is also the largest shareholder of a third of the FTSE 100 companies as well as a top-5 shareholder of 89 of them, the largest shareholder of one-third of the DAX-30 companies, and so on. Vanguard, with more than \$5 trn assets under management in a similarly diversified portfolio, is almost as large, and growing at an even faster rate.

The crux is: when firms predominantly controlled or influenced by shareholders who also hold large stakes in competitors act in these shareholders’ interest, then they should *not* maximize their own value. Instead, they should maximize their beneficial owners’ utilities – i.e. their *portfolio* values. Importantly, own-firm profit maximization and portfolio value maximization are not the same when firms strategically interact. For example, aggressive product price reductions or capacity expansions may increase one firm’s value. However, by

<sup>3</sup>Both active and passive investment strategies at the fund level can lead to such patterns; the key development leading is consolidation of voting and beneficial ownership rights at a more aggregate level than the ultimate ownership. Absent a deliberate attempt to monopolize industries such as in voting trusts of the 19th and 20th century, a high level of consolidation in the asset-management sector can mechanically and perhaps inadvertently lead to the same outcome. The World Bank reports 2016 global stock market capitalization at \$65 trn. An asset manager with \$3 trn invested in equity would thus hold almost 5% of the shares of every firm on the planet, and more if the holdings were clustered in particular industries or geographies.

Table 2: Panel B: Banks.

This table shows the largest (institutional and non-institutional) beneficial owners and corresponding stakes for America's largest banks as of 2017Q2. The data source is *S&P Capital IQ*.

<u><i>JP Morgan Chase</i></u>	<u>[%]</u>	<u><i>Bank of America</i></u>	<u>[%]</u>	<u><i>Citigroup</i></u>	<u>[%]</u>
Vanguard	7.03	Berkshire Hathaway	7.03	BlackRock	6.97
BlackRock	6.40	BlackRock	6.71	Vanguard	6.66
State Street Global Advisers	4.69	Vanguard	6.65	State Street Global Advisers	4.50
Capital Research	3.78	State Street Global Advisers	4.45	Fidelity	4.42
Fidelity	2.68	Fidelity	3.27	Wellington	1.77
<u><i>Wells Fargo</i></u>	<u>[%]</u>	<u><i>PNC Financial</i></u>	<u>[%]</u>	<u><i>U.S. Bancorp</i></u>	<u>[%]</u>
Berkshire Hathaway	9.85	Wellington	7.59	BlackRock	6.41
Vanguard	6.30	Vanguard	6.73	Vanguard	6.26
BlackRock	5.43	BlackRock	5.68	Berkshire Hathaway	6.08
State Street Global Advisers	4.01	State Street Global Advisers	4.80	State Street Global Advisers	4.38
Capital Research	3.55	Capital Research	4.37	Fidelity	3.84

Table 2: Panel C: Supermarkets.

This table shows the largest institutional and non-institutional beneficial owners and corresponding stakes for a selection of American supermarket chains as of 2017Q2. The data source is *S&P Capital IQ*.

<u><i>Kroger</i></u>	<u>[%]</u>	<u><i>Target</i></u>	<u>[%]</u>	<u><i>Costco</i></u>	<u>[%]</u>
BlackRock	7.89	State Street	9.42	Vanguard	7.67
Vanguard	7.71	BlackRock	8.37	Capital Research	6.24
Capital Research	7.45	Vanguard	6.73	BlackRock	5.68
Fidelity	5.37	Franklin Resources	3.80	State Street	4.14
State Street	4.39	Dodge & Cox	3.63	Wellington	3.31
Janus Capital Mgt.	2.64	Capital Research	3.34	Fidelity	2.46
J.P. Morgan Asset Mgt.	2.23	BNY Mellon Asset Mgt.	1.64	Northern Trust	1.49

definition, one firm's increase in market share comes at the expense of its competitors, and at the cost of lower equilibrium product prices. Aggressive competition can therefore at the same time be in the interest of an individual firm but decrease a common owners' portfolio value. Shareholder diversification across competitors can thus remove firms' incentives to compete, and void Adam Smith's idea that the pursuit of shareholders' self-interest leads to maximization of social welfare.

These insights extend beyond the application to product market competition. Shareholder-value-maximizing firms should internalize all types of externalities they impose on other firms that are horizontally or vertically connected or otherwise affect each other with their actions, to the extent their influential shareholders hold shares in these other firms. Even the most mundane corporate financial decisions can have different value implications for a single firm in isolation than for a portfolio firms. For example, payouts in one firm reduce that firm's ability to invest, but may enable another, formerly more constrained firm that receives these funds to exercise growth options. Large diversified owners should therefore aim for *optimal governance of a portfolio of firms*, whereas existing academic research focuses on governance of single firms in isolation. This consideration is meant to convey that vast and immediately policy-relevant research opportunities present themselves as a result of the secular change in ownership structures illustrated above.

A large number of questions arises: Do between-firm common-ownership links indeed affect corporate conduct? (If not, why do firms not act in their shareholder's interest, and

what is the objective firms maximize instead, if any?) Do firms behave more cooperatively with each other when their largest owners overlap? Do the ownership structures of firms such as Virgin America, Amazon, or Walmart lead these firms to compete more aggressively against their more commonly-owned product-market peers? Do commonly owned firms have incentives to innovate more or less intensely than more closely held firms? What are the implications for equilibrium outcomes – specifically, are product prices higher and is output lower in markets in which the natural competitors are more commonly owned? Do the usual corporate-governance mechanisms suffice to implement such outcomes?

Theory suggests the answer to all these questions is “yes” – this review connects more than three-decades worth of research to this effect. Indeed, the implications of these theories are potentially foundational for the way researchers think about firm strategy and corporate conduct.

Despite the richness of the falsifiable predictions of the theory and the broad scope of common ownership patterns in the real world, the empirical literature examining the theories’ predictions is relatively young. A likely reason is that the theoretical predictions were largely ignored until empirical evidence supporting some of its key predictions emerged in recent years. Until then, researchers simply assumed common ownership would not change the dictum that firms maximize their own value, irrespective of whether doing so has a theoretical foundation or is consistent with shareholders’ interests. As I discuss in the next section, this assumption is only tenable if firms are price takers in all markets or if shareholders are not diversified and have no interests outside the firm. The remainder of the review discusses the papers that tackle the non-trivial case in which firms strategically interact and at least some shareholders are diversified.

The structure of this survey is as follows. Section 2 first discusses the history of financial economics theory leading to the common assumption that firms maximize their own value, as well as the pathbreaking papers that explore the consequences of relaxing that assumption. It then explores alternative approaches in the literature to measuring common ownership and CoOCo at the firm, firm-pair, market, and industry level, and discusses various challenges involved with using these measures in empirical applications. Section 3 first reviews papers documenting the rise of common ownership, then those that provide direct evidence that portfolio considerations enter the way investors engage in governance, and then those providing empirical evidence indicating that CoOCo affects product-market outcomes and other strategic interactions between firms. Section 4 reviews the legal literature, as well as policy proposals triggered by the empirical findings. Section 5 outlines important unanswered questions for future research. Section 6 concludes.

Whereas I attempt to give a comprehensive review of the significant academic literature on CoOCo and corporate conduct, many related streams of thought exist that I cannot cover within the confines of this survey. One omitted category of papers concerns the boundaries of the firm. If “a firm is exactly a set of assets under common ownership” (Holmström & Roberts 1998), the question arises in which sense assets under partial common ownership belong to one firm or another, neither (but instead to the common owners, in various proportions), or both – Lindsey (2008) is the first paper in the finance literature making this point.

I also have to omit the relation between CoOCo and the large literature examining the relation between product-market competition and corporate financial policy, as well as a smaller literature examining asset-pricing effects of indexing and common ownership (see, e.g. Antón & Polk (2014); Bond & Garcia (2017); Kacperczyk et al. (2018)). ETFs are one



contributor to common ownership, and their impact on corporate behavior is subsumed in this survey; Ben-David et al. (2017a) survey the literature on ETF's impact on asset-market quality.

Another closely related literature studies the effect of minority-share acquisitions by competitor firms and common asset holdings by competitors. I briefly refer to this literature in section 2. Absent agency frictions, direct “cross-ownership” links are economically similar to horizontal common-ownership links. However, no alternative assumptions about objective functions of the firm are necessary for cross-ownership to affect firm behavior, because the value of stakes in competitors is directly reflected in the firm's own value. Also, the practical manifestations differ significantly. Antitrust authorities worldwide are keenly aware of cross-ownership links and partial mergers. By contrast, partial common-ownership links created by institutional investors have only recently gained prominence.

Also beyond the scope of this review are the literatures examining the extent to which shareholder incentives and firm objectives and behavior are affected by ownership of company stock by a particular set of actors, such as activists (Brav et al. 2015), employees (Agrawal 2011), foreign sovereign wealth funds (Dewenter et al. 2010), “passive” investors, blockholders (Edmans 2014; Edmans & Holderness 2017), or institutional investors more generally (see, e.g., McCahery et al. (2016)). Making a clear distinction from these literatures is difficult for various reasons. One is that the evidence reviewed in the body of this paper indicates that governance activities, including voting, are often conducted at the fund-family level, also in families that host both active and passive funds. In such a situation, questions such as whether “index funds” engage in corporate governance are moot – index funds may not engage, but their sponsoring families do, jointly with the power of the active part of the family. Also, increases in firm ownership by passive investors imply a decrease in ownership by active investors, making it difficult to judge which of the two is responsible for any change in corporate conduct. A second reason is that the boundaries between activist investors and shareholders without an explicit interest in affecting corporate behavior are blurry when the so-called “passive” investors' voting power becomes large enough to be pivotal in corporate events such as proxy fights; see Gelles & de la Merced (2014); Schmalz (2015); Flaherty & Kerber (2016a) for recent examples. In short, passive ownership may not practically exist when the ownership position is large. The common ownership research agenda therefore puts a unique focus on the actors' economic incentives, which are perhaps more objectively measurable and less arbitrarily defined than “active” or “passive” labels. That said, labels matter, if only because of their regulatory and legal implications. I therefore discuss in section 5 how interactions between these omitted literatures and the common-ownership agenda are likely to offer a fruitful area for future research.

Lastly, all of the above literatures operate under the “narrow and orthodox view” (Tirole 2010) that corporations do or should act in the interest of shareholders – whether these shareholders are diversified across related firms or not. (Hart & Zingales (2017) offer a recent discussion of alternative views.) Within that narrow view, the key insight emphasized in this review may be that optimal governance (including investment strategy, incentive structure, payout policy) and therefore the meaning of the terms “overinvestment,” “underinvestment” and “good governance” can differ across investors, depending on whether they take the perspective of firm value maximization or the perspective of portfolio value maximization.

## 2. THEORY AND MEASUREMENT

### 2.1. Competition and shareholders' unanimous preference for the maximization of firm value

Corporations generally have many shareholders with potentially differing interests. Determination of the firm's objective thus constitutes a social choice problem. Nevertheless, much of corporate finance and industrial organization theory implicitly assumes that firms simply maximize their own value, irrespective of the shareholders' potentially heterogeneous interests. In this section, instead of taking the assumption that firms maximize their own value as an article of faith, I review papers that derive firm objectives from economic principles.

The assumption of own-firm profit (or, more accurately, value) maximization has appeared in formal economic thinking at least since Fisher (1930). Indeed, the Fisher Separation Theorem, which stipulates that corporations maximize their own value, regardless of shareholder preferences, forms the core of much of financial economics theory that followed. Among its assumptions is that firms are price takers not only in capital markets, but also in all factor and product markets. In such a world, no shareholder is hurt if firms simply maximize their own value: any divergence from this policy is without effect, given there are no strategic choices to make in the first place. In other words, when markets are competitive, unanimous support for own-profit maximization obtains, but the result is vacuous. As DeAngelo (1981) points out, there is no strict support for profit maximization, but merely unanimous indifference.

A substantial literature in the 1970s develops sufficient conditions for unanimous shareholder support for profit maximization. Hart (1979) shows the essential assumption is that markets are competitive (rather than complete). Hart also anticipates the literature that followed by noting shareholders may not want firm-value-maximizing behavior when they hold shares in other firms, or when they are consumers of the firm's products. Hart's result raises the question: if not profit maximization, what *is* the firm's objective function when firms interact strategically? In other words, "To what extent will the conduct of firms be different from the assumed profit maximization behavior in classical theory; and if it differs, what ramifications does that have for market outcomes"? (Hart & Holmström 1987).

The answer must grapple with Arrow (1951)'s impossibility theorem, as perhaps most clearly explained by Milne (1981). Either no objective function exists that reflects shareholders' diverging preferences, or at least one of Arrow's axioms has to be violated. Specifically, assuming all shareholders are identical violates Arrow's *unrestricted domain* assumption, but in return yields degenerate cases in which unanimity obtains even when firms have market power and in the presence of uncertainty. One such case is when all identical shareholders hold stakes in only one firm. Then the traditionally-assumed profit maximization objective can be unanimously agreeable. Another special case is when all shareholders hold the market portfolio, as I now discuss.

### 2.2. Diversification and maximization of industry value

Beginning in the early 1980s, various authors have remarked that shareholder diversification can lead to firms' internalizing the externalities they impose on other firms. When applied to models of competition, diversification can thus lead to monopolistic outcomes.

Rubinstein & Yaari (1983) note that two investors, each owning one of two competitors, have an incentive to acquire shares in each others' firms. Doing so removes incentives to compete and allows the shareholders to realize monopoly profits. Rotemberg (1984)

points out that a more benign motivation – mere diversification benefits – can similarly motivate risk-averse shareholders to diversify their portfolios. The original motivation for diversification notwithstanding, the effect is the same: full diversification can lead to an industry- (or economy-) wide monopoly.

Rotemberg makes the ad-hoc assumption that, instead of maximizing their own profits, firms  $j$  maximize a weighted average of their  $M$  stockholder  $i$ -s' utilities:

$$\max_{x_j} \tilde{\Pi}_j = \sum_{i=1}^M \gamma_{ij} U_i. \quad (1)$$

Shareholders have quadratic utility  $U_i$ , and the utility weights  $\gamma_{ij}$  are given by investor  $i$ 's share of firm  $j$ 's capital. The literature that followed, discussed below, has since used – or derived – a structurally similar objective function, but has considered variations in the control weights as well as the shape and arguments of shareholder utilities. Rotemberg's main result is that when identical shareholders are fully diversified, that is, hold equal fractions of shares in all (symmetric) firms, firms' incentives to compete in the product market are annihilated, with the result of output falling to the monopoly level. Whereas he refers to this outcome as “collusive,” he points out that in contrast to the conventional use of the phrase, diversification takes away incentives to deviate from the monopolistic outcome, and therefore no punishment strategies or communication are necessary to sustain this outcome. Each firm's behavior is simply the result of managers maximizing their shareholders' unilateral interests.

Perhaps surprisingly, heterogeneity in shareholder portfolios (and thus shareholder objectives) need not imply shareholders disagree about the objective function of the firm and its competitive strategy, as Rotemberg discusses in a section on unanimity. Indeed, undiversified owners, who wish to maximize the value of their holding of a single firm's stock, may nevertheless agree with diversified owners to soften competition against rivals. The reason is that a soft equilibrium response by said rivals can increase the own firms' profits to a greater level than what can be achieved with an aggressive product-market strategy. Hence, unanimity with respect to soft competition can prevail even when not all shareholders are fully diversified and hence have heterogeneous objectives.<sup>4,5</sup>

What if shareholders also have interests as consumers, and firms internalize these interests? Would Rotemberg's result be overturned? Farrell (1985) proves that when all shareholder-consumers' consumption share equals their ownership share, they unanimously vote for competitive product markets. Otherwise, the profit motive dominates internalization of consumer interests, and output is reduced relative to the competitive level.<sup>6</sup>

The implications of shareholder diversification on corporate behavior extend beyond competition, however. Gordon (1990, 2003) advances the notion that shareholder diversification should also induce managers to internalize *any externality* imposed on commonly

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<sup>4</sup>Rotemberg relies on symmetric firms and ex-ante identical shareholders to derive unanimity; shareholders may have divergent interests ex post because they may choose different portfolios due to transaction costs.

<sup>5</sup>As Milne (1981) had explained previously, holding identical portfolios is not sufficient for unanimity to obtain amid uncertainty and in the presence of market power. Differences in consumption sets, endowments, or beliefs, or differences in risk preferences amid uncertainty about the future can also lead to disagreement about the firm's optimal strategy.

<sup>6</sup>Azar (2017) develops a modified Herfindahl index that takes ownership and control by shareholder-consumers into account.

owned firms.<sup>7</sup> Gordon also develops a model to rationalize the scarcity of relative performance evaluation of top managers observed in the data; he argues this finding is easy to understand when shareholders are diversified and thus want firm to maximize industry profits as opposed to firm profits, and avoid compensation schemes that reward managers for embarking on projects that increase the value of one firm at the expense of another. Macho-Stadler & Verdier (1991) similarly show that managerial incentives to deviate from profit maximization depend on the degree of “cross-participation” in the ownership structure, concluding that such links can make firm less aggressive competitors. Various authors have since elaborated on these points; see, for example, Rubin et al. (2006); Kraus & Rubin (2010); Antón et al. (2016). Kraus & Rubin (2010) and Antón et al. (2016) also offer empirical evidence consistent with their models’ predictions.

Apparently independently from these earlier papers, Hansen & Lott Jr (1996) reiterate several of the previous points, but also explore a number of new hypotheses that common ownership may explain, including the internalization of R&D spillovers, litigation costs, and the internalization of interests of shareholders that are also employees of the firm. Perhaps more importantly, these authors also offer a first empirical analysis; see Section 3.

### **2.3. Alternative objectives of the firm, managerial incentives, and firms’ production choices when shareholders disagree**

The above discussion relied on unanimous support of industry value maximization as an objective of all firms. However, monopolization by way of diversification can also arise when unanimity fails, that is when shareholders disagree about the firms’ objective functions. This claim is trivially true if one assumes that one shareholder with a fully diversified portfolio controls all firms (violating Arrow’s non-dictatorship axiom in each firm), whereas a sufficient mass of other shareholders has different portfolio interests but no control.

In less extreme cases, discussed by Rotemberg as well, battles for control between diversified and undiversified shareholders may determine firms’ competitive strategies. Along these lines, Gordon (1990, 2003) develops a model of competition for corporate control between diversified and undiversified shareholders, and also discusses some asset-pricing implications of a change of control. Ex post, a single dominant shareholder (or block of shareholders with aligned incentives) controls the firm. A single parameter then reflects the extent to which the dominant shareholder also holds stakes in related firms, and hence the degree to which firms internalize externalities imposed on others. That parameter can then be used to derive comparative statics with respect to common ownership and guide empirical analyses. Antón et al. (2016) use such a model to study executive compensation under common ownership (a topic first proposed by Rotemberg for future research, and previously discussed by Gordon and various other papers since). Antón et al.’s key insight is that active engagement in governance by common shareholders is not necessary for internalization of portfolio interests, including but not limited to anticompetitive effects of common ownership, to materialize. The reason is that an active *steepening* of managerial incentive slopes can be necessary to induce more aggressive competition between firms. The omission by common owners to engage in designing steep managerial incentives can lead to less competition in equilibrium, because flatter top-management incentives imply

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<sup>7</sup>Crès & Tvede (2005) show how unanimous support for full internalization can obtain in a formal voting model.

attenuated incentives to reduce costs and increase output, which in industry equilibrium can lead to higher prices, margins, and profits. Their model thus shows agency conflicts between shareholders and managers do not necessarily weaken the predictions of the above theories. Instead, agency conflicts that may reduce incentives especially of passively diversified investors to engage in governance (Bebchuk et al. 2017) can be the vehicle by which CoOCo reduces investment and output, and at the same time increases industry profits. Because shareholders design incentive contracts the manager takes as given, their model also clarifies that managers need not be aware of their and competitor firms' ownership structures for common ownership to affect corporate behavior.

Absent a dominant shareholder, the search for a theoretically grounded objective function of the firm amid shareholder disagreement becomes much more challenging. An applied theoretical and empirical literature in industrial organization has hence employed an ad-hoc objective function similar to (1) primarily to enable the study of competitive effects of direct shareholdings of one firm in a competitor, or of common ownership of individual assets by competitors (although some also explicitly discuss partial common ownership of competitors).<sup>8</sup> Specifically, O'Brien & Salop (2000) assume firms (indexed by  $j$ ) maximize a weighted average of their  $M$  shareholders' ( $i$ ) portfolio profits that arise from cash-flow rights  $\beta_{ik}$  in  $N$  different firms ( $k$ ) that generate profits  $\pi_k$ , whereas the  $\gamma_{ij}$ s are the respective shareholders' control shares:

$$\max_{x_j} \tilde{\Pi}_j = \sum_{i=1}^M \gamma_{ij} \sum_{k=1}^N \beta_{ik} \pi_k = \pi_j + \sum_{k \neq j} \underbrace{\sum_i \gamma_{ij} \beta_{ik}}_{\lambda_{jk}} \pi_k. \quad (2)$$

This objective has several attractive properties:

1. It reflects the notion that firm  $j$  internalizes externalities on other firms  $k$  (*only*) to the extent  $\lambda_{jk}$  that owners with financial interest in firm  $k$  ( $\beta_{ik}$ ) have control over firm  $j$  ( $\gamma_{ij}$ ), relative to the control and cash-flow rights they have in firm  $j$ . In particular, if there is a costless action firm  $j$  can take that benefits other firms in  $j$ 's most powerful investors' portfolio, it will do so.
2. Absent common-ownership links, the objective collapses to own-profit maximization.
3. More common ownership and control are reflected in a continuous fashion. That is, the measure imposes no artificial ownership cutoffs.
4. Full diversification implies firms maximize total industry profits.
5. It reflects that large shareholders have relatively more influence on the firm's behavior than a collection of small shareholders with diverging interests that is equally large in aggregate.
6. Its elements have empirical counterparts, and are thus measurable.

Another attractive feature of objective (2) is that it can be microfounded in economic theory. Specifically, Azar (2017) (based on Azar (2012)) offers probabilistic voting models

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<sup>8</sup>Areeda & Turner (1978); Rubinstein & Yaari (1983); Bernheim & Whinston (1985); Reynolds & Snapp (1986); Bresnahan & Salop (1986); Farrell & Shapiro (1990); Ellerman (1991); Flath (1991, 1992); Bolle & Güth (1992); Malueg (1992); Nye (1992); Bøhren & Michalsen (1994); Reitman (1994); Alley (1997); Parker & Röller (1997); Bøhren & Norli (1997); Dietzenbacher et al. (2000); Allen & Phillips (2000); Amundsen & Bergman (2002); Dasgupta & Tsui (2004); Ono et al. (2004); Clayton & Jorgensen (2005); Gilo et al. (2006); Foros et al. (2011); Shelegia & Spiegel (2012); Brito et al. (2014); Nain & Wang (2016); Fotis & Zevgolios (2016); Heim et al. (2017); Levy et al. (2018)

in which managers propose strategies with the goal of maximizing either the vote share cast in their favor or the probability of winning, and that yield an objective function with the structure of (2). The fact that voting can yield this objective is important because it clarifies that no mechanism other than voting is necessary to make firms behave in accordance with their shareholders’ interests: managers simply execute their previously advertised strategic plans. Azar’s model also generalizes Rotemberg’s result along various dimensions, such as the model of competition, and shows that the conclusion that full shareholder diversification leads to monopoly can persist amid some forms of *ex-ante* shareholder heterogeneity. Brito et al. (2017) offer an otherwise similar voting model that can jointly capture not only common ownership, but also direct equity stakes of firms in competitors (“cross-ownership”); they also derive a common-ownership-generalized GUPPI, which is a useful tool for applied antitrust analyses.

Small variations in these models’ assumptions yield empirically meaningful variation in predictions with respect to how the control weights  $\gamma_{ij}$  in equation (2) should be measured. For example, depending on whether candidate managers maximize the probability of winning an election, the vote share, or whether they choose strategy proposals to maximize the expected utility from holding office, control weights are best captured by vote shares (as in Rotemberg) or Banzhaf indexes (as first proposed in an earlier version of Azar (2017)). That distinction is potentially important: it determines whether a single common owners (or set of beneficial owners) holding 51% of the voting shares of an industry’s firms can bring about full monopoly, or whether the remaining 49% of potentially undiversified owners still have a voice. Yet other variations yield the prediction that Shapley values should be used to measure control. In Moskalev (2017)’s otherwise similar model, a key distinction is that shareholders with similar portfolios will have similar voting strategies and can be regarded as one block.

According to objective (2), what matters for the role of common ownership in corporate conduct is not merely the degree to which various sets of shareholders are diversified, but the extent to which *the firms’ most powerful shareholders* hold shares in related firms. As a result, this objective also captures why increasing consolidation in the asset-management industry (see, e.g., Figure 1 of Ben-David et al. (2017b)) and coordination between diversified investors can affect corporate conduct: aggregation of ownership and control can not only increase common ownership but also make common owners *relatively* more powerful shareholders. More fundamentally, this consideration suggests that the secular shift from direct investment by households in firms to intermediated asset management with joint control over the households’ shares can itself change corporate objectives and behavior.

Note that a simple measure of the overlap of two firms’ shareholder bases, such as a dummy equal to 1 if a common blockholder exists between two firms, does not share many or all of the above features and absorbs much useful information. For example, such an approach ignores whether very large controlling investors are present that render smaller common blockholders powerless. It also ignores how large any common blockholder’s position is. (Is it 5.1% for both firms, or is it 51%?)<sup>9</sup> It may therefore be useful to distinguish

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<sup>9</sup>Many other measures have been proposed in the literature – including the minimum of shares held by the same actor in a pair of firms, the product of these shares, the maximum of these shares, and so on (see, e.g., Harford et al. (2011); Azar (2012); Gilje et al. (2017); Banal-Estanol et al. (2017)). These measures appear less economically meaningful because they don’t explicitly recognize the relative power of different shareholders in shaping firms’ behavior. That said, which measure best describes firm behavior empirically is an important open question. Therefore, experimentation

between such simple “dummy” measures of common ownership and more involved measures such as (2); I refer to the latter as CoOCo.

## DEFINITIONS

### Common ownership

Incidence or frequency of shareholder overlap between firms.

### Common-ownership concentration (CoOCo)

The extent to which influential shareholders in one firm also hold ownership stakes in firms that are affected by the firm they have influence over, and vice versa.

I next demonstrate a fifth appealing feature of objective function (2): it can be used to condense the information contained in all firms’ ownership structures into a scalar measure of the extent to which common-ownership incentives affect a given market’s competitiveness.

## 2.4. Predictions about product market equilibria

Replacing the own-profit-maximization assumption with the objective function (2) in a standard Cournot model, O’Brien & Salop (2000) show that industry markups (the wedge between price  $P$  minus marginal cost  $C'$ ) are proportional ( $\eta$  is the price elasticity of demand) to a modified Herfindahl Index  $MHHI = HHI + MHHIdelta$ , where  $s_j$  is the market share of firm  $j$ :

$$\eta \sum_j s_j \frac{P - C'_j(x_j)}{P} = \underbrace{\sum_j \sum_k s_j s_k \frac{\sum_i \gamma_{ij} \beta_{ik}}{\sum_i \gamma_{ij} \beta_{ij}}}_{MHHI} = \underbrace{\sum_j s_j^2}_{HHI} + \underbrace{\sum_j \sum_{k \neq j} s_j s_k \frac{\sum_i \gamma_{ij} \beta_{ik}}{\sum_i \gamma_{ij} \beta_{ij}}}_{MHHIdelta}. \quad (3)$$

Similar to equation (2), the  $MHHIdelta$  term reflects the extent to which influential shareholders of firm  $i$  have economic interests in firm  $k$ , relative to their interests in firm  $j$ . In the language of network theory, it reflects the density of the network of ownership and control between the firms under consideration.  $HHI$  is the special case that obtains when firms maximize their own profits. Equation (3) predicts higher markups (or prices conditional on cost), along with lower output, and hence lower consumer welfare, in markets with more CoOCo.

**2.4.1. Why the rise and consolidation of intermediated asset management can matter for firms’ competitive incentives.** As we approach empirical applications using this measure, it is important to understand some of its key properties. Perhaps most importantly, the measure reflects that the reduction in competitive incentives is greatest when the firms’

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with different measures is a valued direction for future research.

most influential shareholders – those with the highest control shares ( $\gamma$ ) – have relatively greater economic interests ( $\beta$ ) in competitor firms. Whereas there is no consensus in the literature on how shareholder structure translates into control shares, a popular and intuitive assumption is that more votes correspond to more control.<sup>10</sup> That assumption implies that if a set of ultimate shareholders or fund managers de facto assigns their voting rights to a common, centralized institution such as a voting trust or a governance and proxy voting office of a mutual fund family, the resulting entity has a greater control share of portfolio firms than the individual ultimate investors or fund managers jointly conferred. If that centralized entity acts in the interest of the the portfolio of cash flow rights attached to the pool of shares it represents (which can have different characteristics than the portfolio of each individual ultimate investor or fund), CoOCo can be higher than it would be in a dis-intermediated world in which many small, ultimate shareholders have diversified portfolios, but relatively larger, undiversified shareholders have greater control shares. It is thus that the rise and consolidation of intermediated asset management can make diversified owners relatively more powerful “shareholders” and lead to a reduction in competitive incentives of portfolio firms. This consideration also illustrates why it is important in empirical applications to measure beneficial ownership at the level control is de facto exercised to compute the  $\beta$ s and  $\gamma$ s entering measures of CoOCo.

**2.4.2. Discussion of key assumptions and properties of MHHIs.** When we attempt an empirical evaluation of the above predictions, it is important to keep in mind the assumptions underlying the derivation of the common ownership measure used. Focusing on MHHIdelta, one key assumption is that market shares as well as ownership and control are taken as given; in practice, all of them are likely endogenous to firm strategy. For example, entry – and therefore market shares – may depend on margins, which according to the theory depend on ownership. The incentives to enter may themselves depend on the ownership structure between incumbent and potential entrant. Relatedly, entry could occur not only by different firms, but also by corporate raiders or activist investors. Activists should be more willing to acquire target shares if they can expect support for their proposed strategic plans from existing shareholders; see Brav et al. (2017) for evidence. Moreover, the activist’s willingness to enter by buying shares should depend on the price at which she can acquire the necessary shares, whereas both the share price and the required vote share the raider has to acquire to be able to influence the firm depends on the entire industry’s ownership structure. The literature lacks models that conclusively clarify that endogeneity; see section 5. For these reasons, empirical tests of the predicted effect of common ownership on product market outcomes have to attempt to isolate exogenous variation in ownership from endogenous variation in both ownership and market structure.

Moreover, these considerations make it reasonable to expect that the empirical relevance of the above theories may vary across industries with different barriers to entry. Managerial agency problems over and above the desire to remain in office (as reflect in the voting mod-

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<sup>10</sup>Rotemberg (1984) assumes that control shares are proportional to the fraction of shares. This assumption is only valid in special cases, however, such as when all shareholders are small. Moreover, increasing control rights can also have the counterintuitive effect of reducing control shares: Parsons et al. (1999) point out such apparent paradoxes that arise when cross-ownership links are present at the same time as common ownership links and Shapley values are used to quantify control. Incidentally, these authors are also the first to my knowledge to explore the suitability of MHHI to quantify the increase of concentration due to common ownership of firms by industry outsiders.



els discussed above as microfoundations for the assumed objective function) are also not reflected in this measure; the empirical importance of this feature is uncertain at this point, and presents an attractive area for future research. Relatedly, there is a debate among legal scholars whether constraints imposed by corporate officers' fiduciary duty would prevent firms to act in the interest of diversified shareholders: if the correct or customary interpretation of the duty was that it requires maximizing the own firm's value (as opposed to acting in shareholders' economic interest), and if deviations from this duty were observable and likely to come with adverse consequences to officers, then firms might internalize the externalities they impose on related firms even if all shareholders of the firm held the market portfolio; see Easterbrook & Fischel (1982) for a discussion of whether taking actions that benefit different shareholders differently is consistent with officers' fiduciary duty. The above models don't take the possibility of such frictions into account, which underscores the importance of empirical work to validate the models' predictions.

While attractive for reasons laid out above, an undesirable property of MHHI is that it only varies at the market level (as opposed to  $\lambda_{jk}$  from equation (2), which varies at the market-firm level); when no market-level data but only firm-level data are available, the measure only varies at the industry level. This property perhaps unnecessarily limits the usable variation in the data. Another disadvantage concerns measurability of the key variables entering MHHIs. Specifically, even product-market studies often only observe prices, but not margins. Hence, even regressions of price conditional on proxies for costs such as market-firm fixed effects and time-fixed effects are not a precise measure of the left-hand side of equation (3).<sup>11</sup> In short, reduced-form tests that use MHHIdelta as a measure of CoOCo can raise questions of interpretation. Hence, developing alternative measures of CoOCo and supplying structural models of competition under common ownership are desirable avenues for future research.

Researchers should also keep in mind that the above model doesn't allow for an endogenous choice of cost parameters. López & Vives (2016) show that common ownership can mitigate firms' well-known disincentives to innovate that can arise from technological spillovers. Under restrictive conditions, common ownership can even increase cost-reducing innovation to an extent that increases output and welfare. To derive more differentiated testable predictions, Antón et al. (2017) extend Lopez and Vives' model and derive comparative statics of the common-ownership effect on innovation with respect to differential degrees of technological and product-market spillovers, respectively. Shelegia & Spiegel (2017)'s model studies innovation in a duopoly model that allows for asymmetric common-ownership links.

Before thinking about empirical designs to test these predictions, several measurement and data challenges have to be overcome.

## 2.5. Measurement and data challenges

A number of measurement and data challenges apply to all measures of common ownership the literature has used. Specifically, the challenges concern the measurement of control shares, ownership data sources and aggregation of ownership stakes to the level at which

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<sup>11</sup>See O'Brien (2015) for a critical discussion. Although not discussed as such, these concerns could perhaps also apply to analyses relating to *changes* in prices and CoOCo. O'Brien's critique does not supply evidence that the examples in which MHHIdelta and price covary negatively are empirically relevant.

control is exercised, as well as issues of market definition.

First, the control share of owner  $i$ ,  $\gamma_{ij}$ , is not necessarily the same as the share of control rights owner  $i$  holds. For example, a beneficial owner controlling 51% of the voting rights may have 100% control over the firm. As this example illustrates, the divergence between the share of control rights an investor commands and the share of control she exercises becomes particularly acute when a small number of investors controls a large fraction of control rights. This is often the case in firms with dual-class shares. Measuring “control share” is difficult not only because there is no generally agreed-upon voting model that translates ownership structure to control structure, but also because the share of board seats, or even the influence specific board seats yield, could matter significantly, too. Researchers should thus ensure that their results are robust to alternative ways of measuring control shares. For example, Azar et al. (2018a) offer baseline results assuming a 1:1 correspondence between control rights and control shares, but show robustness to the assumption that control shares correspond to Banzhaf voting-power indexes.

Relatedly, relying solely on ownership data from institutional shareholdings (typically 13f filings) to construct measures of CoOCo can be inadequate. First, all of the largest owners of the firms in **Table 1** would not be accounted for, although in many cases, they are the shareholders with the most significant control rights. Ignoring individuals, in particular those undiversified ones at the top of individual firms’ ownership structures and those holding dual-class shares, will tend to give undue weight to common-ownership links.<sup>12</sup> Solely relying on 13F data could wrongly suggest that BlackRock and Vanguard’s holdings in Walmart and Berkshire Hathaway conferred infinitely more control over strategy than what the Walton family and Warren Buffett enjoy, and can artificially inflate measures of CoOCo.

Third, in various instances, asset owners such as insurance companies, and asset managers such as mutual fund companies file separate 13f’s for various subsidiaries or sets of funds, respectively. However, governance and voting is usually conducted at the family level, especially for the larger fund families with a predominantly passive investment approach.<sup>13</sup>

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<sup>12</sup>The incidence of dual-class shares is perhaps surprisingly large, also in the United States. S&P Capital IQ flags 931 corporations that are publicly traded on a major US stock exchange as having dual class shares. The list includes some of the world’s most valuable companies; 162 of them have a market cap greater than USD \$1bn; 252 have a market value greater \$500m. The list includes traditional firms such as Comcast, Ford, Nike, and UPS; technology firms such as Alphabet, Expedia, Facebook, and Snapchat; finance firms such as Berkshire Hathaway, Interactive Brokers, and Visa; media companies such as CBS and Twenty-First Century Fox.

<sup>13</sup>Posner et al. (2017) note that State Street’s governance and voting policy states that they employ “a centralized governance and stewardship process covering all discretionary holdings across our global investment centers. This allows us to ensure we speak and act with a single voice and maximize our influence with companies by leveraging the weight of our assets.” <https://corpgov.law.harvard.edu/2017/12/21/passive-fund-providers-and-investment-stewardship/> cites a survey finding that “atBlackRock, Amundi, and UBS, the policy is for active fund managers to vote consistently across all funds, but they retain the authority to vote differently from the house view. This contrasts with the approach adopted at Vanguard,SSgA, and LGIM, where the corporate-governance teams have ultimate authority on the final votes.” Empirically, Fichtner et al. (2016) show that Vanguard funds do not vote with one voice on only 0.0006% of proposals. The respective number for BlackRock is 0.00018% and 0.00195% at State Street. This compares to much higher (but still low) within-family disagreement at Fidelity with 3,144 divergent votes per 100,000 events; see also a discussion in Elhauge (2018). Because mutual fund families derive their revenues primarily from charging a percentage of the value of assets under management as a fee, their incentives are largely aligned with the ultimate investors’ interest of maximizing port-

Failing to aggregate 13f's at the family level can therefore lead to an underestimation of the combined clout of a fund family's votes or those of an asset owner splitting 13f reporting across subdivisions, and can thus lead to an underestimation of the respective control share of the beneficial owner and noisy measures of CoOCo.<sup>14</sup> Subsidiaries with different names from the parent are another source of potential error. For instance, New England Asset Management (US Bancorp's 10th-largest shareholder) is a subsidiary of Berkshire Hathaway.

Azar et al. (2018a) address the latter two problems by complementing institutional-holdings data with information from manually collected proxy filings for each airline and quarter, and by manually aggregating ownership and control shares of funds within the same family. This approach is of course more challenging for studies involving a larger number of firms, but no less important. For across-industry studies, the only feasible solution may be to source the data from providers that offer consolidated and aggregated ownership and control information from 13f filings, proxy statements, and other sources.<sup>15</sup>

Fourth, predictions about effects of CoOCo on corporate conduct in general, and on competition in particular, of course suppose the commonly owned firms in fact interact. Interacting is not equivalent to sharing the same NAICS or SIC code, because industry definitions don't necessarily correspond to markets. Suppose two airlines, W and E, fly non-overlapping sets of routes in the Western and Eastern United States, respectively. One might reasonably assume no significant competitive effects obtain if these airlines were put under common ownership. However, common ownership of carriers that compete head-to-head on most of their routes is more likely to affect competition. Studies that use industry codes as the market definition do not differentiate between these scenarios, and are therefore more likely to produce biased results. Note this issue is a general concern with using industry-concentration measures, not just with MHHI. In sum, the delineation of the market in which researchers can reasonably expect competitive effects of common ownership is important, and industry-level studies are likely to define markets too broadly.

Ignoring the issue of market definition can lead to misleading impressions about the actual degree of market concentration. To illustrate, **Figure 1**, taken from Azar et al. (2016), shows time trends in average market concentration and industry concentration in US deposit banking. Because the number of banks in the United States is very large, the level of concentration measured at the national ("industry") level is small. Concentration at the local ("market") level is several times larger, because not every bank competes in every market. At either level, concentration that takes both common-ownership and cross-ownership links into account (GHHI) is much greater than concentration measured with the HHI. (HHI counterfactually assumes a complete absence of common ownership or cross-ownership.)

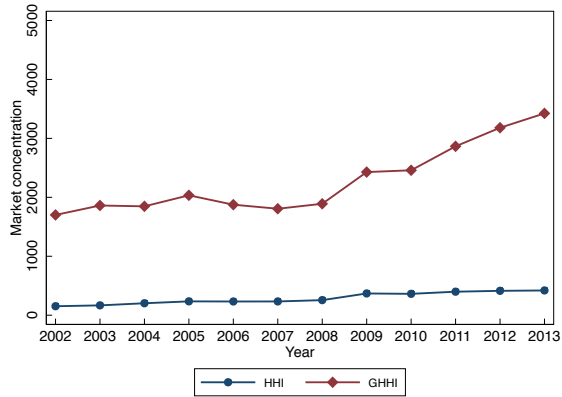
Of course, for many applications, tradeoffs have to be made between the above-mentioned criteria. For example, most studies of corporate behavior are limited to firm-level

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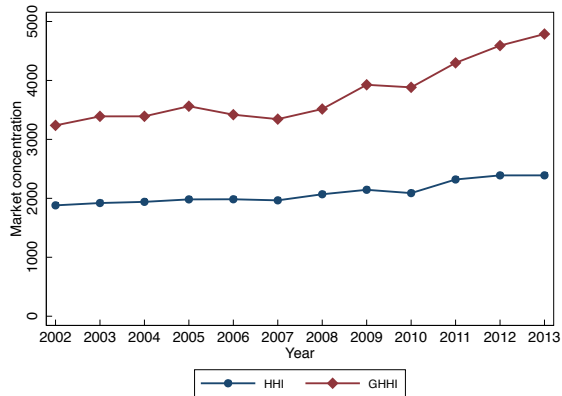
folio values. Hence, *fund manager* incentives have little to do with the incentives relevant for the exercise of shareholder rights; a frequent mischaracterization of fund families' incentives involves citing fund managers' focus on maximizing (relative) returns or minimizing tracking error.

<sup>14</sup>This aggregation problem is independent of the well-known errors in the Thomson Reuters 13f data, which occur especially during the later years of the sample and the largest mutual fund families.

<sup>15</sup>Azar et al. (2018b) show that attenuated estimates of product market effects of common ownership reported by Dennis et al. (2017) are due in part to omitting aggregation.



(a)



(b)

Figure 1: (a) National-Level Bank Concentration, 2002-2013, taking the entire United States as a unified market. Bank concentration is measured using the HHI and GHHI; (b) County-Level Bank Concentration, 2002-2013, calculated as the deposit-weighted average across counties of county-level bank concentration as measured with HHI and GHHI.

data; product-level information is rare. Studies that have the ambition to speak to changes in competitiveness at the scale of the macroeconomy have no choice but to define industries at a level much broader than individual markets.

### 3. EMPIRICAL EVIDENCE

#### 3.1. Documentation of common-ownership links

In his conclusions, Rotemberg (1984) explicitly points to the possibility that mutual funds – and specifically sector funds – could bring about the predicted reductions in competition. The first empirical documentation of institutional investors’ common ownership of competitors I am aware of is by Hansen & Lott Jr (1996), who shows such links in the computer

and auto industries. Whereas Gilo (2000)'s legal analysis focuses on cross-ownership cases, he also motivates his paper with examples of common-ownership links in the rental car and "on-line computer services" industries. Davis & Yoo (2003) document the number of block-holdings by mutual funds in connected firms, and refers to them as "common ownership." Davis (2008) sees a "new finance capitalism" in the "re-concentration" of US industries through mutual funds. Matvos & Ostrovsky (2008) provide ownership tables similar to those provided in this review across merging parties in the financial industry. Lindsey (2008) documents that alliances are more frequent among companies sharing a common venture capitalist, and provides evidence that such links help overcome contracting frictions and have the effect of blurring firm boundaries. Harford et al. (2011) document the increase in common-ownership links between S&P 500 firms from 1985 to 2005, and "conclude 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." Azar (2012) reports an increase in the ownership network density within broad industry classifications, also calculated from 13f institutional holdings. Azar et al. (2018a) and Azar et al. (2016) are the first to document an increase in CoOCo at the market (as opposed to the industry) level in the US airline and deposit banking industries, respectively. They furthermore show that variation in CoOCo dwarfs variation in the traditional HHI, and that the levels of CoOCo, as measured by MHHI $\Delta$ , vastly exceed commonly used thresholds for antitrust screens.

### 3.2. Direct evidence for the internalization of portfolio interests

Hansen & Lott Jr (1996), examining a sample of 252 mergers from 1985-1991, argue that negative acquirer returns can be better understood by taking into account the bidder's shareholders' holdings in the target. The idea, perhaps first reflected in Easterbrook & Fischel (1982), is that positive target returns at least partially compensate common owners for negative bidder returns. Matvos & Ostrovsky (2008) find similar results on announcement returns in a larger sample; Gompers & Xuan (2009); Masulis & Nahata (2011) find similar results for VC acquisitions.

Matvos & Ostrovsky (2008) moreover show that mutual funds that hold shares in both the target and acquirer are relatively more likely to vote for mergers with negative acquirer announcement returns compared to shareholders with holdings only in the acquirer. This voting evidence is difficult to explain with theories other than the internalization of shareholders' interests in other firms, and thus constitutes perhaps the clearest evidence at the time that common ownership concerns are present and important in corporate governance decisions. They are also the first to point out the conflict of interest between different shareholders in the context of M&A.<sup>16</sup>

Another important result in Matvos and Ostrovsky's contribution is to show that funds that don't have holdings in the target are more likely to vote for the merger if other funds of the fund family they belong have holdings in the target. Hence, they provide evidence consistent with within-family across-fund subsidization for the benefit of the overall family.

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<sup>16</sup>Harford et al. (2011) argue the shareholder overlap between targets and acquirers is not large enough to plausibly influence bidder behavior, and show that a different measure of common ownership yields insignificant results on bidder announcement returns. However, they do not challenge Matvos & Ostrovsky (2008)'s main result on voting.

Given that votes on mergers are binding, one may conjecture (as suggested in Matvos and Ostrovsky’s conclusions) that common ownership makes mergers more likely. Brooks et al. (2016) provide evidence consistent with that hypothesis.

An interesting question all of the above papers leave open is how merger terms and prices are set as a function of the ownership structure not only of the merging parties but also the other firms in the industry. It is possible, for example, that common owners may support a merger without benefiting from either acquirer or target returns. They may benefit instead as a shareholder of a third firm in the industry.

The above papers focus on effects of common-ownership links on outcomes at the shareholder and firm-pair level. One advantage is that the evidence quite directly supports the hypothesis that shareholder portfolio interests enter firms’ objective function; another advantage is that reduced-form measures of common ownership at the firm-pair level are relatively easy to develop. However, many of the policy-relevant implications of common ownership concern the effect of horizontal common-ownership links on product-market competition. To study such equilibrium outcomes, the entire ownership and control network of the relevant competitors has to be taken into account.

### 3.3. Effects of horizontal common-ownership links on corporate conduct and product market outcomes

**3.3.1. Industry- and firm-level evidence.** The papers discussed in this section seek to address the question of whether CoOCo has the effect of changing firms’ strategic behavior and equilibrium outcomes. To approach an answer to this question, Azar (2012) shows that an increase in a reduced-form measure of a within-industry common-ownership density predicts industry margins, but industry margins don’t, conversely, predict common ownership. He also shows that common-ownership links *across* industries are associated with *lower* markups. The latter finding is at odds with the hypothesis that common owners simply select into holding more profitable firms, whereas both the within- and the across-industry findings are consistent with an internalization of shareholder portfolio interests in corporate conduct as well as anticompetitive effects from common ownership within an industry. He & Huang (2017) report that firms sharing common blockholders experience greater market-share growth and operating profitability, which jointly suggests cost synergies from common ownership, rather than anticompetitive effects. Semov (2016) finds that commonly owned firms move closer together in product space and hold lower cash, with is consistent with a response to reduced competition and greater incentives to coordinate or collaborate on product market strategies.

Both studies only consider the presence of owners holding blocks of at least 5% in the affected firms, and omit individual owners, which may raise concerns discussed in section 2.5. Perhaps more importantly, unobserved time trends at the industry level could potentially drive the documented correlations. Measuring common ownership at the industry as opposed to the market level further complicates the interpretation of the evidence as illustrated with the comparison of market- versus national-level bank concentration in section 2.5.<sup>17</sup> In sum, various concerns with industry-level analysis challenge a causal interpretation

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<sup>17</sup>An omitted size control in He & Huang (2017)’s analysis moreover raises the potential for a spurious relationship between percentage-point market-share growth (which mechanically depends on size) and the presence of a common 5% blockholder (which correlates with size).

of a negative correlation between CoOCo and higher margins.

Because of these concerns with broad studies based on industry-level of firm-pair level variation in common ownership, testing the hypothesis reflected in equation (3) that higher CoOCo causes higher product market margins can perhaps more convincingly be performed with an industry study that uses more granular market-level price and quantity data. The reason is that omitted time trends at the industry or even firm level can be differenced out with fixed effects, thus mitigating concerns about omitted variable bias. Even so, a convincing identification strategy also has to rule out reverse causality as an alternative explanation for a positive correlation between margins and CoOCo.

**3.3.2. Market-level evidence.** The first examination of the effects of CoOCo on market-level outcomes is the airlines study by Azar et al. (2018a). The key advantage of focusing on variation across markets within a single industry is that many identification concerns present in the above industry-level studies can be differenced out with fixed effects. An advantage of the U.S. airline industry is that all the data used in the study is publicly available. Moreover, each route can be regarded as a fairly well-defined market.<sup>18</sup> Azar et al. (2018a)'s baseline regressions estimate the coefficient  $\beta$  in a panel regression of route-airline-quarter level ticket prices on the level of CoOCo in route  $r$  in year-quarter  $t$  (as measured by MHHIdelta), whereas the effect of industry concentration (as measured by HHI) and various potential confounders  $X_{rjt}$  such as time-varying route and airline ( $j$ ) characteristics are explicitly controlled for. In addition, many potential confounders such as macroeconomic conditions or market-specific peculiarities are differenced out with various combinations of firm, quarter-year, and route fixed effects ( $\alpha_{jt}$  and  $\nu_{rj}$ ).

$$\log(p_{rjt}) = \beta \cdot MHHIdelta_{rt} + \gamma \cdot HHI_{rt} + \theta \cdot X_{rjt} + \alpha_{jt} + \nu_{rj} + \varepsilon_{rjt} \quad (4)$$

The baseline findings are:

- The sensitivity of ticket prices to CoOCo,  $\beta$ , is robustly negative – ticket prices are 3%-8% higher than in a counterfactual world without common ownership. This finding formally rejects the null hypothesis of no product market effects of CoOCo.
- Passenger volume is lower when CoOCo is higher, suggesting that unobserved demand shocks don't explain the price effects.
- The effect of CoOCo on prices is larger in routes with higher passenger volume, but insignificant for the smallest 16% of markets, indicating that the effects are not driven by economically less important markets.<sup>19</sup>
- The effects are qualitatively similar when alternative market definitions or measures of control shares (such as Banzhaf voting power indexes) are used to compute MHHIdelta.
- The effects are attenuated or insignificant when the authors assume in the calculation of MHHIdelta that control is exercised by small or temporary shareholders, or when

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<sup>18</sup>Parker & Röller (1997) have previously shown in a structural estimation that common ownership of an *asset* is linked to higher prices: when telecom companies commonly own licenses in a given market, prices are estimated to be higher. Similarly, Lundin (2016) shows that common owners of Swedish nuclear plants choose to perform maintenance, and thus withdraw capacity from the market in a coordinated way and when the price effect of doing so is particularly large. Such behavior fits a model of joint profit maximization better than profit maximization at the individual plant level.

<sup>19</sup>For reference, 90% of passenger volume is produced in the largest 50% of airline markets.

carriers go through bankruptcies. These findings are consistent with corporate governance realities, but also indicate that the endogeneity of market shares – a concern discussed in section 2.4.2 – does not drive the main results.<sup>20</sup>

In sum, these panel regressions address various concerns that are present in previous industry-level studies, chiefly due to the more granular nature of the data and the use of a large number of fixed effects. However, the endogeneity of market shares, perhaps due to reverse causality, remains a concern that limits especially the quantitative interpretation of these baseline results. To investigate the effect the endogeneity of ownership may have on the estimated price effects, Azar et al. (2018a) use the acquisition of one very large asset management firm by another to obtain quasi-exogenous variation in ownership and from that construct a market-level instrument for CoOCo. They find the estimated price effects from the instrumental variable regressions to be larger than in the panel regressions – up to 12%. This finding suggests that the endogeneity of ownership biases panel estimates towards zero, and increases confidence in the internal validity of the estimate that CoOCo may reduce product market competition in this industry. These results are difficult to explain with theories other than that variation in CoOCo causes variation in product prices.

However, as in any empirical study, the interpretation of these findings is subject to numerous caveats and assumptions. For example, alternative measures of CoOCo are likely to yield different results, and which measure of CoOCo is most reflective of empirical realities is an open research question, as discussed above. Relatedly, the derivation of MHHIdelta is based on a Cournot model of competition, which may be more appropriate for some applications than others. Moreover, the predicted relationship is between markups and MHHIdelta, which may be different from the empirically measured relationship between price, conditional on market-fixed effects and other controls meant to absorb marginal costs. In other words, readers should keep in mind the reduced-form empirical specification (4) is not derived from a structural model. The statistically causal evidence does also not answer the question which particular shareholders or governance mechanisms, if any, are primarily responsible for these outcomes; see Section 3.5 for a discussion. Another potential concern is that the U.S. airline industry is special, for example in that regulation imposes high barriers to entry. Therefore, questions about external validity of these results may arise.

**3.3.3. External validity.** Azar et al. (2016) find a positive effect of CoOCo on the prices of retail deposit products and a negative effect on deposit interest rates. Aside from providing evidence of external validity, the study also contributes a qualitatively different measure of ownership concentration, GHHI. This is important because direct cross-holdings of shares in competitors significantly contribute to ultimate ownership concentration in the US banking sector. The paper also shows that regressions of price on industry structure (as measured by HHI) may not yield significant coefficients, because HHI and ultimate ownership concentration (GHHI delta) are negatively correlated. Therefore, omitting ownership structure from measures of industry structure leads to a negative omitted variable bias. These results inform a debate in industrial organization on the appropriateness of inferring changes in competitiveness from changes in industry structure, which have been dismissed in part

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<sup>20</sup>An alternative approach to avoiding the potential endogeneity of market shares would be to use the incentive terms  $\lambda_{jk}$  from equation (2). Antón et al. (2016); Gramlich & Grundl (2017) are working papers employing that approach.



based on the ineffectiveness of HHI in capturing variation in markups; see, e.g., Schmalensee (1989).

Market-level studies are attractive because they feature relatively well-defined markets, which I have illustrated above can have very different ownership characteristics than broadly defined national industries. However, data limitations would dramatically constrain the scope of studies of CoOCo on corporate conduct if only market-level studies were “permissible.” To study potentially systemic effects of CoOCo, some internal validity has to be sacrificed for external validity. Gutiérrez & Philippon (2016) show that the rise of industry concentration and common ownership is correlated with firms’ reluctance to invest despite high profits, both within and across industries; see also Panayides & Thomas (2017); see Gutiérrez & Philippon (2017) for causal evidence. Saidi & Streitz (2018) find an effect of common debt ownership on product market competition as well: a higher proportion of firms sharing the same lender and higher credit concentration in an industry is associated with lower output. The rise of common ownership may thus help explain the confluence of low real interest rates and low investment amid high corporate profits that has puzzled macroeconomists for the past decade (Krugman 2007, 2014; Summers 2016).

In sum, there are now many pieces of evidence that could suggest that more CoOCo leads to less competition, but many open questions remain. One open question concerns a possible “efficiency defense.”

### 3.4. Evidence for potentially welfare-increasing effects of common ownership

The above papers document likely anti-competitive effects of horizontal common-ownership links. However, that doesn’t mean that CoOCo is welfare-decreasing in all industries or on average. Instead, as discussed in section 2, horizontal CoOCo can have welfare-enhancing effects for example when technological spillovers are large. Moreover, vertical common ownership links can presumably have welfare-reducing or -enhancing effects as well, similar to the effects of full vertical integration, although no formal theoretical investigation to this effect exists to my knowledge.<sup>21</sup>

Indeed, there exists an emergent literature hinting at the empirical validity of this hypothesis. Lindsey (2008)’s results suggest that common ownership can help overcome contracting frictions. Cici et al. (2015) and Freeman (2016) find a greater incidence and robustness of business relationships between vertically connected firms, mirroring the results by Fee et al. (2006) who show longer-lasting customer-supplier relationships when the customers directly own shares in the supplier. Ojeda (2017) documents that when a firm and a bank have common ownership, the firm obtains larger loans from the bank at a lower interest rate. Geng et al. (2017) find vertical common-ownership links mitigate hold-up problems arising from patent complementarities. Lastly, Antón et al. (2017) examine how CoOCo affects R&D investments and innovation output; see also Kostovetsky & Manconi (2016); Qiu (2017).

### 3.5. Governance channels

The empirical link between changes in CoOCo and changes in product prices raises the question of which corporate governance mechanisms translate the diversified common sharehold-

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<sup>21</sup>The closest paper may be Levy et al. (2018). Hence, the existence of vertical common ownership links doesn’t obviously contradict horizontal effects of common ownership.

ers' interests to corporate policy. Azar et al. (2018a) offer the most comprehensive discussion of what we know of the particular governance activities common owners perform; I provide a short summary here, and complement it with some more recent evidence.

First, whereas much common ownership is driven by asset management families with predominantly passive investment strategies, it is important to clarify that passive investment strategies don't imply a passive approach to ownership. Passive ownership would involve not voting shares, but all of the large mutual fund families do. Indeed, all mechanisms that are known to be used to translate shareholder interests into corporate behavior are also at the disposal of common shareholders, whether they employ active investment strategies (e.g., Berkshire Hathaway or PRIMECAP, referencing Table 2) or primarily passive strategies (e.g., Vanguard). The active/passive distinction is furthermore complicated by the fact that active and passive funds' shares within a fund family tend to be voted jointly by a centralized corporate governance office (see footnote 13), muting the question of whether "passive ownership" or "index funds" have an effect on governance outcomes. The current policy discussion on whether *index funds* have an adverse effect on competition and therefore should be prohibited is severely misguided for that reason alone; another reason is that much common ownership is driven by purely active strategies or sector funds that concentrate rather than diversify risks; see Schmalz (2017) for a more comprehensive discussion.

Relatedly, some have argued that passive funds' competitive pressures imply their primary objective is cost reduction, leading to reduced incentives to engage to increase the value of the firms they beneficially own on behalf of their investors, see an informal discussion in Bebchuk et al. (2017). The premise of this argument is disputed and appears to conflict with empirical facts, as discussed below. However, even if it was true, reduced incentives to engage do not imply that passive ownership doesn't affect governance outcomes and firm behavior. For example, Antón et al. (2016) show formally that common owners may indeed have reduced incentives to engage with the goal of enhancing efficiency or reducing cost, not because of inter-fund competition, but because cost reductions in multiple firms of the industry don't necessarily lead to higher industry profits and portfolio values. Instead, engagement and steeper incentives not only causes higher governance and compensation costs, but also leads to increased output, which can lead to lower product prices and margins in industry equilibrium. Hence, less engagement to increase individual firms' value can lead to the maximization of industry value, perhaps even as an unconscious outcome of limited involvement in corporate governance.

**In other words, "doing nothing" is a mechanism by which common owners can induce portfolio firms to internalize shareholders' interests in other firms, including their anticompetitive incentives.**

Thus, the seemingly competing explanations for the increasing disconnect between profitability and investment – agency conflicts (Krugman 2007) and market power (Krugman 2014) – may in fact be complementary. In other words, passive investors can be "lazy" owners (as *The Economist* has alleged) and harm competition at the same time.

That said, large asset managers may in fact have incentives to increase portfolio values through governance, because higher asset values imply higher revenue from management fees (which are typically a percentage of assets under management). Lewellen & Lewellen (2018) empirically assess whether additional fees arising from increases in portfolio values would justify engagement by asset managers and conclude that "Our estimates suggest that institutional investors often have strong incentives to be active shareholders." Edmans

et al. (2018) study theoretically the effect of common ownership on incentives and ability to engage in governance, and conclude that common ownership can strengthen governance. Jahnke (2017)

If common owners engage with the explicit aim to reduce competition, they can use (i) voice, (ii) incentives, and (iii) their vote to do so – the only tool not available to those common ownership that follow passive investment strategies is “exit” – that is, selling their shares.

Azar et al. (2018a) provide anecdotal evidence for the voice channel. In particular, see Flaherty & Kerber (2016b) for an example of engagement by a common shareholder of competitors; see Waldmeir & Kwan (2017) for an example of shareholders putting United Airline’s CEO “under pressure for slashing fares and for increasing the supply of flights and seats.”<sup>22</sup>

This interaction is not an isolated incident or specific to the airline industry. The Wall Street Journal<sup>23</sup> reports on a meeting between 12 shareholders for the purpose of finding strategies “how to make frackers pump less and profit more” and “curb their dependency on growth.” One participant “has asked several shale producers why they appear hellbent on giving away their product as fast as possible at low prices,” hearing “it’s what The Street” wants as a response. He continues “We wanted to provide another voice that says, ‘We’ve got skin in the game, and we don’t want to see you do that.’”

The same investor meeting “homed in on the role executive pay plays in driving a growth-at-all-costs mentality.” Gilo (2000) provides detailed numerical examples on how compensation contracts can be used to align managerial incentives with those of shareholders holding stakes in competitors. Antón et al. (2016) provide evidence that these examples generalize: in the sample of Compustat firms, common ownership is associated with lower wealth-performance sensitivities at the industry level.<sup>24</sup>

Matvos & Ostrovsky (2008) show direct evidence that shareholders take portfolio considerations into account in voting decisions, as previously discussed in Section 3.2. Not only voting patterns but also voting outcomes have been documented to depend on the extent of common ownership: Azar (2012) shows that firms that share common owners are more likely to share common directors, and Buhayar (2016) reports an example in which one firm’s shareholders choose a representative of a competitor’s largest shareholder as a director. Schmalz (2015) illustrates with a case study how voting can have the effect of preventing activist involvement that would likely lead to more aggressive industry competition.

All of the above mechanisms are premised on the assumption that managers unilaterally act in the interest of their shareholders, and do not explicitly or tacitly coordinate

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<sup>22</sup>Interestingly, United management did not face similar investor pressure following the display of “capacity discipline” featuring the forceful removal of a passenger from a plane in April 2017. This is not surprising, given that United’s largest shareholders gained financially in the wake of the incident, as gains in their holdings in United’s competitors more than compensated for the decline in United’s stock price; see Levine (2017) for a discussion.

<sup>23</sup><https://www.wsj.com/articles/wall-streets-fracking-frenzy-runs-dry-as-profits-fail-to-materialize-1512577420>

<sup>24</sup>An earlier working paper version of Antón et al. (2016) also documented a negative association between relative performance incentives and common ownership, as first predicted by Gordon (1990). Liang (2016) finds similar results using different measures and methodologies. Kwon (2016) reported a positive association based on different industry definitions, data sources, and ownership measures.

with competitor firms. Evidence for an association between common ownership and pay-for-delay in pharmaceutical industry provided by Gerakos & Xie (2018), however, suggests that explicit agreements between firms may also play a role in implementing anticompetitive effects of common ownership. These authors show that common ownership between brand and generic drug manufacturers is positively related to the likelihood of a settlement agreement in which the brand pays the generic to stay out of the market, with a delay in the sale of generics, and with the brands daily abnormal returns around the settlement agreement. Aside from suggesting an explicit channel of anticompetitive conduct associated with common ownership, the paper also constitutes the first study of how entry depends on the industry's ownership structure.<sup>25</sup>

However, agreements need not be explicit; more subtle changes in firm behavior can also increase the ability of firms to coordinate implicitly. For example, firms can disclose more details about their product market strategy to investors. This information is also visible to competitors and may help soften competition; see Aryal et al. (2018) for evidence that communication in earnings calls softens competition in the U.S. airline industry. Pawliczek & Skinner (2018) document a positive correlation between CoOCo and voluntary disclosure of product market related information in 10-K and 10-Q filings, and corroborate their evidence by using variation from the BlackRock-BGI acquisition as a plausibly exogenous shock to CoOCo.

In sum, irrespective of how active common owners' governance activities are, as long as they encumber voting rights that could otherwise be used by undiversified concentrated shareholders, common owners' incentives are likely to be reflected in corporate behavior because of the lack of incentives to do otherwise. To the extent common owners actively engage in governance, any of the usual corporate-governance channels can be used to induce firms to act in their shareholders' interest.

However, research to provide empirical support for most channels remains limited and their relative importance is not well understood. Therefore, there is scope for numerous research projects to identify which governance channels are employed by various types of investors, and which of these channels are important in influencing firm behavior. The finding of various alternative governance channels would have policy implications, because it would imply that shutting down particular channels would not be a promising policy response to concerns about anticompetitive effects of common ownership. In that case, a more promising route to prevent undesirable influence by common owners would be to reduce the anticompetitive incentives. The policy proposals discussed in the following section are primarily based on that premise.

## **4. LEGAL ASPECTS OF HORIZONTAL SHAREHOLDINGS AND POLICY RESPONSES**

### **4.1. Legal aspects**

As reflected in the review thus far, perhaps the most consequential documented effects of CoOCo are anti-competitive product-market outcomes. Long before such empirical results

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<sup>25</sup>Common ownership may also be related to the establishment of cross-ownership links, which may deter entry or encourage exit from product markets, as suggested by press coverage of Softbank's involvement in Uber's decision to sell its operations in China to commonly owned rival Didi, in exchange for a cross-ownership stake in Didi.

were on the horizon, Roe (1990)'s analysis of the legal limitations to institutional shareholdings touched on several aspects of the antitrust problem. For perspective, at the time of Roe's writing, mutual funds in aggregate controlled assets worth \$548bn (about \$1trn in 2017-dollars). Nowadays, a single mutual fund family, BlackRock, controls more than \$6trn.

Roe cites from the 1934 Senate securities ("Pecora") report: "The investment company has become the instrument ... to facilitate acquisition of concentrated control of ... the industries of the country. [...] The concentration of control ... the mutual funds facilitated served no productive function, served merely to pervert the use of the controlled companies and was detrimental to the public welfare. [...] Congress must prevent the diversion of these trusts from their normal channels of diversified investment to the abnormal avenues of control of industry." The resulting Investment Company Act of 1940 declared that "the national public interest ... is adversely affected ... when investment companies have great size and have excessive influence on the national economy." FDR himself called out the shift from individual and independent ownership of business to the concentration of unwarranted economic power in such "holding companies," thus creating a form of "private socialism" and threatening to bring about government socialism.<sup>26</sup> Roe also notes that "institutional investors have considered joint action to affect management and, I understand, an important consideration militating against joint action was fear that political regulation would follow."

A quarter century later, the world's largest common owners nowadays regularly convene for "secret summits," in which they discuss how they can most effectively influence their portfolio firms (Foley & McLannahan 2016). Indeed, doing so may be the most effective way to have an influence in governance and overcome freerider problems. These actions occurred several years after the SEC began to exert significant pressure on institutional investors to take a more active stance in corporate governance (see, e.g., 17 CFR Part 275 RIN 3235-AI65), thus boxing institutional shareholder into a difficult position between satisfying security and competition regulators' potentially conflicting demands.

Roe also discusses the conflicting goals of diversification that mutual funds offer to ultimate investors, while at the same time avoiding antitrust problems that come with control, and yet maintaining good governance of the portfolio firms. Azar (2012) refers to this conflict as a "trilemma," because only two of these three goals can be perfectly and simultaneously attained. Roe appears to see less of a conflict as he voices skepticism of large institutions' ability and incentives to effectively monitor firms to the benefit of social welfare, consistent with the theoretical considerations and empirical evidence in Antón et al. (2016): "The networks could siphon resources for banker profit and still fail to monitor managers effectively; they could become politically intolerable concentrations of economic power."

Gilo (2000) is the first legal analysis I know of that specifically focuses on the anticompetitive effects of common and cross-ownership. He discusses the potential for Clayton Act Section 7 violations in the context of purely passive investments in competitors, emphasizing such investments may substantially harm competition "even when firms are not colluding," and proposes that executive compensation schemes that reward managers for competitor

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<sup>26</sup>The underlying logic is that common ownership removes incentives to compete, and thus the foundation of capitalism as a successful system of production – irrespective of whether the common owners are private actors or the government. A question not explicitly discussed in Roe's paper is whether the resulting limitations imposed on funds also apply to fund *families* that exercise joint control over a large number of funds' shares.

performance should be banned through Section 5 of the Federal Trade Commission Act. He also anticipates the current literature in his discussion of potential efficiency gains from common ownership. Finally, he agrees with current policy proposals (see below) that the only effective remedy to avert anti-competitive effects of passive investments in competitors is (“obviously”) to divest.

Wilkinson & White (2006) and Norbäck et al. (2018) discuss antitrust concerns and enforcement actions related to partial common ownership acquisitions in private equity. In particular, Wilkinson and White point to legal precedents that give competition authorities “green light to scrutinize the investments ... in two competing portfolio companies – even where the investments result in no controlling interest by either competitor and the levels of cross-ownership are relatively small.” They also recommend the calculation of modified HHIs to assess the competitive risks arising from the change in incentives from partial common-ownership links.

Elhaug (2016) offers the first assessment of the concrete legal implications of the empirical findings of anti-competitive effects of common ownership by Azar et al. (2018a) and Azar et al. (2016). In short, he emphasizes that even if no evidence of collusion exists<sup>27</sup> and hence a clear violation of the Sherman Act’s Section 1, Clayton Act Section 7 still prohibits acquisitions of assets – explicitly also below a level that confers control – that lessen competition.<sup>28</sup> A key argument in his paper is that the so-called passive-investor exemption to the Clayton Act requires that shareholders do not vote or otherwise influence companies *and* that their ownership does not in fact have the effect of lessening competition. Given that even so-called “passive” institutions do vote their shares, and given Azar et al. (2018a)’s results, Elhaug concludes that existing patterns of common ownership do not satisfy the requirements for the passive-investor exemption. Elhaug also details the potential for large-scale violations of the Hart-Scott Rodino (HSR) Act, a concern since reflected in the press (Flaherty & Kerber 2016a) and by regulators (Feinstein et al. 2015), and discusses the potential role of CoOCo in explaining otherwise puzzling macroeconomic trends.

Baker (2016) offers a “qualified agreement” with Professor Elhaug’s assessment. Scott Morton & Hovenkamp (2017) likewise argue that patterns and effects of common ownership can be a violation of existing antitrust laws, but offer a more focused guidance on how suits may be organized in the U.S.. A vivid theoretical debate continues in the law journals (see, e.g., Patel (2017); Rock & Rubinfeld (2018); Ginsburg & Klovers (2018)). Elhaug (2017a) offers a review.

Given the international scope of the antitrust risks associated with partial common-ownership links, Elhaug (2017b) offers an assessment of how anti-competitive effects of common ownership can be addressed within the confines of EU competition law. Elhaug (2017b) also updates his earlier HLR paper with respect to the applicability of existing US

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<sup>27</sup>The key insight from both the theoretical and empirical literature is indeed that horizontal CoOCo can lessen competition by changing unilateral incentives. In fact, the potential for collusion becomes less acute when unilateral incentives to compete are lessened by CoOCo and drive markets toward monopolistic outcomes already; see de Haas & Paha (2016) for the most recent formal model of collusion under common ownership.

<sup>28</sup>Indeed, O’Brien & Salop (2000) share this assessment in the context of direct cross-holdings of one firm in another: “Section 7 of the Clayton Act covers the acquisition of ‘any part’ of the stock of another company if deemed anticompetitive. The statute does not require acquisition of stock sufficient to confer control; nor does it contain a threshold or a minimum stock purchase amount.”

antitrust law, and in particular Sherman Act Section 1.

Whereas the likely success of suits according to various laws in various jurisdictions is subject to debate, the literature seems to agree that large asset managers should ensure that they have robust antitrust compliance programs in place.

## 4.2. Policy proposals

It is important to keep in mind that the question of whether present-day common-ownership links violate existing antitrust laws is different from the question of whether enforcing any such violations would improve economic welfare. With such welfare considerations in mind, a first policy proposal by Posner et al. (2017) points out an apparent problem with suits according to the Clayton Act as proposed by Elhauge: if a concentrated owner sells her shares to small individual investors and thus creates greater CoOCo (imagine Jeff Bezos liquidating his Amazon shares, thus making more diversified shareholders relatively more powerful), institutions with pre-existing common-ownership links could be liable although they didn't do anything to bring about the increase in CoOCo. The authors thus propose a safe haven for institutions that would require them to either limit their holdings in any one company to 1% of the outstanding stock, or to concentrate their holdings in one firm per industry. They also offer a first quantitative evaluation of the loss of diversification benefits due to diversifying across industries alone. They conclude such a loss would be negligible compared to the increase in economic efficiency from more competitive product markets.

An additional likely benefit of Posner et al.'s proposal is that increased concentration of asset managers' shareholdings in one firm per industry would enhance the institutions' incentives to improve corporate governance. The alternative policy of restricting common owners' voting rights, proposed by Shapiro Lund (2018), would arguably lead to a greater divergence between cash flow and control rights, thus creating greater corporate-governance frictions, and perhaps preventing socially beneficial governance activities by the large institutional investors. Adding to the theoretical appeal of Posner et al.'s proposal, increased concentration of an asset managers' holdings in vertically connected firms (as opposed to dispersed holdings across firms in an industry) could also have welfare-improving effects, to the extent the premise of the "efficiency defense" is correct – namely, that vertical common ownership has, on average, quantitatively important welfare-enhancing effects. These conjectures have not been evaluated by formal models; doing so constitutes an important task for future research.

The above proposals are perceived by many as far-reaching, and therefore controversial. A hopefully less controversial proposal would be that policy makers demand and collect and analyze accurate beneficial ownership information and details on the governance activities of institutional investors, including the level at which governance rights are de facto exercised. In particular, regulators should be aware of the "aggregation" problem discussed in section 2.5 that can understate the extent of CoOCo due to some investors' split reporting of holdings. To the extent asset managers have an interest in a transparent and fact-based debate, they could voluntarily make such data openly available to academic researchers as well.<sup>29</sup>

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<sup>29</sup>Many other possible policy responses have not been discussed in detail, such as the use of taxes to discourage patterns of asset holdings that create anticompetitive incentives, the promotion of entry and entrepreneurship, the prevention of creation of common ownership links by active investors, the prevention of centralization or coordination of governance activities across funds, etc.

Antitrust authorities worldwide have begun to examine the competitive implications of common-ownership links.<sup>30</sup> As a result, the asset-management industry has invested significant resources in discrediting the underlying research and discouraging policy responses. A detailed discussion of such non-academic and industry-sponsored papers on the subject is beyond the scope of this review. Popular misconceptions – in particular that “index funds” are the only or key culprit in bringing about anti-competitive effects, and that addressing the competitive risks from common ownership implies prohibiting index funds – are discussed by Schmalz (2017).

## 5. OPEN QUESTIONS AND CHALLENGES FOR FUTURE RESEARCH

Given that the recent empirical findings challenge no less than a decades-old assumption about the objective of the firm, some expect these findings are “likely to spawn a whole field of study” (Solomon 2016), with the literature reviewed above being just the beginning. Indeed, many old questions can be revisited through the lens of shareholder value maximization rather than own-firm-profit maximization. New questions arise for theorists and empiricists alike.

### 5.1. Additional industry studies and structural estimates

One example of such an opportunity is to reexamine industry studies of product market competition, while allowing for the possibility that common ownership affects outcomes. Studies covering also jurisdictions outside the United States might be particularly informative for policy makers. Besides adding to the reduced-form evidence, researchers may find it useful to offer structural estimates as well, to help address challenges of interpretation inherent in existing reduced-form studies. Structural estimates also allow to more reliably quantify the pricing effects of common ownership, and gauge the likely welfare consequences of implementing policy proposals that aim to change CoOCo in an attempt to try and balance the partially conflicting goals of shareholder value maximization, competition in factor and product markets, innovation, and ultimate shareholder diversification.<sup>31</sup>

### 5.2. Quantifying welfare tradeoffs

Another open question regards a quantitative assessment of the utility benefits investors achieve from diversifying across versus within-industries. Such estimates would help evaluate the likely welfare effect of some of the policy proposals discussed above. That said, restricting diversification at the asset manager level does not necessarily restrict ultimate shareholder diversification, because households can diversify across intermediaries. The primary policy goal should arguably be to allow for cost-effective ultimate shareholder diversification, as opposed to full diversification of intermediaries.

In other words, the key to fixing the competition problem is to restore and maintain incentives to compete *at the level corporate governance activities are effectively conducted*,

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<sup>30</sup>See European Commission Article 8(2) Regulation (EC) 139/2004, Case M.7932 – Dow/DuPont; or the OECD’s conference on common ownership and competition, including the review by Capobianco (2017). Azar & Schmalz (2017) and Azar et al. (2017) cover additional developments.

<sup>31</sup>In ongoing work, Backus et al. (2018) estimate a structural model of demand in the U.S. ready-to-eat cereal industry, which allows them to test and quantify pricing effects of common ownership.



which can be different from the level at which diversification is achieved. Future theoretical work could ascertain the conjecture that informational frictions between ultimate investors and asset managers and ultimate investors' ability to select asset managers are sufficient to generate second-best contracts (as currently in place) that reward asset managers for maximizing assets under management (rather than the interests of shareholder-consumers) and thus break the premise of the problem studied by Farrell (1985). (Full internalization of consumer interests might otherwise imply that diversification by ultimate investors across asset managers can reduce firms' competitive incentives even if asset managers are not diversified within industry.) The key policy tradeoff would then not be between beneficial owner diversification, shareholder value maximization, and product market competition, but between transactions costs of diversification to ultimate shareholders and product market competition, as reflected in Rotemberg (1984)'s original paper.

A likely important aspect that has received less attention in the policy debate concerns the potential welfare benefits of governance activities by large, diversified institutional investors. Quantitative estimates of such benefits would be desirable to inform the policy debate. Estimating factor market effects of CoOCo (e.g., monopsony in the labor market) would likewise help with obtaining a full picture of welfare effects.

### **5.3. Documenting welfare-enhancing effects of common ownership**

As discussed in section 2.4.2, it is theoretically possible that vertical common ownership has welfare-enhancing effects. However, empirical investigations of effects of vertical common-ownership links are constrained not only by a dearth of data, but also by the absence of clear theoretical guidance. Providing such guidance would therefore be a useful addition to the literature.

### **5.4. Governance mechanisms**

Which governance mechanisms are chiefly responsible for common-ownership effects appears to be of interest to corporate-governance researchers, legal scholars, and policy makers. A related question is which (type of) shareholders are chiefly responsible for any anti-competitive or pro-competitive effects of common ownership. Also: are the effects due to commission of anti-competitive actions or omission of pro-competitive directions one would expect from non-common concentrated owners? Either could cause the variation in CoOCo as measured in extant empirical work. Variations of these questions include whether the effects are due to the presence and power of diversified investors or the absence of a large, even more powerful undiversified investor; whether they are due to the presence of passive shareholders or the absence of active shareholders, and so on. Of course, because shareholders have to sum to 100%, passive ownership is just the flip side of active ownership, and the presence of one shareholder type implies the absence of another, and so forth. This consideration sheds doubt on whether these questions are well defined. Various researchers are working on the more interesting question of whether, how, and under which conditions different shareholder types interact in an explicitly or implicitly coordinated fashion.

### **5.5. Endogenizing ownership and market structure in general equilibrium**

The literature on anti-competitive effects of horizontal common ownership thus far relates market outcomes to the ownership and control structure of the network of competitors,

holding constant the size and identity of competitors, that is, the market structure. However, investigating whether product-market structure is endogenous to the ownership and control links between incumbents and potential entrants could also be interesting. Also, the extent to which product market structure and competitiveness may drive CoOCo is not well understood. Studying any such dependences may be a fruitful area for research for both theorists and empiricists.

For example, evidence suggests activist engagement depends on other investors' holdings and preferences (Kedia et al. 2016), whereas activism is known to lead to changes in product-market structure (Aslan & Kumar 2016). An empirical study of such a dependence would likely necessitate a selection model with endogenous firm strategies, asset prices, and ownership by at least some shareholders: if firm profits depend on common ownership, equilibrium asset prices should likewise be a function of ownership and market structure. More generally, understanding the endogeneity of ownership structures of competitors is a very interesting theoretical question for future research. López & Vives (2016) characterize socially optimal levels of common ownership amid the potential for technological spillovers, but it is not known under which conditions a decentralized equilibrium would implement the socially optimal allocation.

More generally, all of the papers discussed in this review operate in partial equilibrium. Given the worldwide and systemic changes in ownership structure of public firms across all public markets due to the rise and consolidation of intermediated asset management, however, general equilibrium effects of CoOCo (including those from vertical common ownership) may have to be considered to assess the overall efficiency effects of this development. Whether common ownership is pro- or anticompetitive in such a context is a very interesting question for future theoretical research.

## 5.6. Tackle the question: what is the objective function of the firm?

Perhaps the most consequential question for future studies in both industrial organization and financial economics concerns what is the objective function of the firm. I have emphasized in section 2 the decades-old literature observing that we lack a theoretical foundation for own-profit maximization under realistic conditions. At the same time, the literature lacks an agreed-upon alternative objective, or an answer to the question of how we should study firm behavior if an alternative objective function does not exist. The various alternative objective functions the literature has entertained are only candidates, and many of them are ad hoc. A first-order goal for future research should therefore be to continue the development and testing of voting models that take into account shareholders' varying portfolio interests.<sup>32</sup>

## 6. CONCLUSIONS

The commonly made assumption that firms maximize their own value ceases to have a robust theoretical foundation when firms interact strategically and the shareholder bases of firms overlap. Both theory and empirical evidence indicate a realistic model of corporate conduct should take into account shareholders' portfolio interests.

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<sup>32</sup>Related working papers include Bubb & Catan (2018); Bolton et al. (2018); Bar-Isaac & Shapiro (2017); Cvijanovic et al. (2017).

Yet no one “correct” model has been identified, which leaves opportunities for theoretical research. In addition, existing theories have made a large number of falsifiable predictions both about corporate behavior and about resulting equilibrium outcomes that have not yet been tested. New research in the area can have immediate policy implications. Therefore, both theoretical and empirical research on CoOCo and corporate conduct will likely remain an attractive area of study in the foreseeable future.

## DISCLOSURE STATEMENT

I hold a portfolio of ETFs. Other than that, I am not aware of any affiliations, memberships, funding, or financial holdings that might be perceived as affecting the objectivity of this review.

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