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**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

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**Common ownership by institutional investors and its impact on competition - Note
by Portugal**

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This document reproduces a written contribution from Portugal submitted for Item 6 of the 128th OECD Competition committee meeting on 5-6 December 2017.

More documents related to this discussion can be found at www.oecd.org/daf/competition/common-ownership-and-its-impact-on-competition.htm

Please contact Mr. Antonio Capobianco if you have any questions about this document
[E-mail: Antonio.Capobianco@oecd.org]

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Portugal

1. Incentives to compete under common ownership

1. “Common ownership” describes the situation whereby large institutional shareholders (e.g., mutual funds and, mostly, private equity funds) hold minority shareholdings in a number of companies that are active in the same industry and compete with each other.

2. The overlapping ownership interests among competitors may raise concerns regarding the incentives to compete. Even if institutional investors hold passive stakes, their financial interests may nonetheless be influential in the business strategy of firms in the market, as managers may internalise their stakeholders’ financial interests and common ownership in their objective function.

3. The increase of institutional investors in many sectors and many countries brought and added relevance to the topic for competition policy, as in some cases, several competitors are jointly held by a common set of institutional investors. The rising trend of common ownership sparked the interest of academics and competition law enforcers on the topic that has been claimed to be “the *great, but mostly unknown, antitrust story of our time*” (E. Posner, F. Scott Morton and G. Weyl, 2016).¹

4. In the absence of common ownership, undertakings thrive to gain market share at their competitors’ expense. If a shareholder owns stakes of a similar range in several undertakings active in the same market, the benefit the common shareholder would gain if one of those undertakings were to increase its market share and profits is offset by the loss incurred with the decrease of market share and profits of the other undertaking. In other words, institutional shareholders that invest in several undertakings active in the same industry are more interested in the performance of the industry as a whole, rather than in the performance of one particular undertaking.

5. As a result, common ownership may potentially soften competition in the competitive equilibrium, where each firm acts in its unilateral self-interest, as well as increase the likelihood or frequency of collusive outcomes in the market. If the common shareholders crowd-out separate owners as the most influential shareholders, firms’ strategic choices will be governed by the incentives of common shareholders and will thus compete less aggressively.² Common ownership may also affect the competitive conditions in the industry by enhancing the degree of information transparency. To this respect, it is also interesting to note that according to the results of Boone and White (2015)³, firms’ information and trading environments increase as a result of institutional

¹ “The great, but mostly unknown, antitrust story of our time is the astonishing rise of the institutional investor — a large company, like a mutual fund company, insurance company, pension fund or asset management firm, that buys stock in substantial quantities for the benefit of clients and customers — and the challenge that it poses to market competition” E. Posner, F. Scott Morton and G. Weyl, “New York Times, December 2016.

² J. Azar, M. Schmaltz and I. Tecu “Why Common Ownership Creates Antitrust Risks” CPI Antitrust Chronicle June 2017.

³ A. Boone and J. White (2015), “The effect of institutional ownership on firm transparency and information production” Journal of Financial Economics 117: 508–533.

ownership. While this empirical study concerns within firm information environment and abstracts from any common shareholdings, it might nonetheless be relevant for the extent of the potential information flow in a common ownership context.

6. Some recent empirical studies analysed common ownership by institutional investors in competing firms in concentrated markets and reached the conclusion that where there is a significant degree of common ownership, competition may be harmed and prices may increase. Azar et al (2017)⁴ analyse the US airline industry and find a robust correlation between route-level variation in concentration over time and the variation in airfares on the same route. For the banking sector, Azar et al (2016)⁵ find the generalised HHI (GHHI) (capturing common ownership - the degree to which banks are commonly owned by the same investors - and cross ownership - the extent to which banks own shares in each other) to be strongly correlated to all prices.

7. These results, the debate that surrounds them and the trend towards an increase in the relevance of institutional investors raises important questions and challenges for competition policy enforcement.

2. Common ownership and the legal framework for merger control

8. Merger control in Portugal closely follows the EU regime and, as such, there is no jurisdiction over transactions which solely involve the acquisition of non-controlling shareholdings⁶. With this in mind, from a Portuguese merger control regime's perspective, the relevance of the topic of common ownership in competing firms by institutional investors may also have relevance of a possible enforcement gap in terms of jurisdiction.

9. Although currently common ownership/minority shareholdings are not an element conferring jurisdiction over a merger, they are nevertheless encompassed in the competitive assessment of a duly notified merger, pursuant to the Portuguese Competition Act. The AdC's Horizontal Mergers Guidelines⁷ specifically addressed the impact of minority shareholdings on the incentives to compete:

“Minority shareholdings (...) must be considered in the competitive assessment to the extent of their impact on the incentives governing firms’ market strategies. When defining its market strategy, a firm that holds minority shareholdings in other firms that supply related products will consider the potential impact of its strategic choices on those firms’ profits in the proportion of its financial interest on each them (i.e, its share on the profits of those firms).

⁴ J. Azar, M. Schmaltz and I. Tecu (2017) “Anti-Competitive Effects of Common Ownership”, Journal of Finance, forthcoming.

⁵ J. Azar, S. Raina and M. Schmalz, (2016), “Ultimate Ownership and Bank Competition”. Available at: <https://ssrn.com/abstract=2710252> or <http://dx.doi.org/10.2139/ssrn.2710252>.

⁶ The acquisition of non-controlling minority shares does not constitute a concentration within the meaning of Article 36 of the Portuguese Competition Act (Law No 19/2012). Only transactions that confer control over an undertaking are deemed to be a concentration, and thus, potentially subject to mandatory notification to the Portuguese Competition Authority (“AdC”) if the legal thresholds for notification are met.

⁷ Cfr. AdC’s Horizontal Merger Guidelines p. 70.

If the firm holds shareholdings of firms supplying rival products, when considering whether to raise prices, the firm internalizes the diverted sales following the price increase to the products of its competitors where it holds a minority shareholding.⁸⁹ As a result, minority shareholdings in rival firms soften competition in the market. On the other hand, if the firm is planning to increase prices and has minority shareholdings in firms that supply complementary products, it will take into account those firms' potential losses due to the decrease in sales, in the proportion of its financial interest on those other firms. ”

10. It is thus foreseen in the Horizontal Merger Guidelines of the Portuguese Competition Authority – Autoridade da Concorrência (AdC) that the analysis of common ownership might entail an adjustment of the screening/assessment tools, namely on the formula of the HHI and the Delta.

11. The Merger Notification Form specifically requests information on minority shareholdings in order to include, among others, situations of common ownership. Specifically, the Notification Form requests information on: *“Personal and financial relationships: List the undertakings operating in the relevant market(s) (...), in which the directors of the participating undertakings discharge a similar function. List the undertakings operating in the relevant market(s) (...), in which the undertakings (...) individually or conjointly possess a minority percentage (i.e. less than 50%) of the voting rights or of the capital issued or other securities. Indicate the respective holders and percentages held.”*

12. This information might now be reinforced due to the recent publication of Law No. 89/2017. This Law transposes into national law Chapter III of Directive (EU) 2015/849, 20 May, approving the legal framework of the Central Register of Beneficial Ownership (CRBO).

13. In practical terms, the CRBO will act as database under the Registry and Notary Institute, and will encompass the identification details of natural persons who own property (including non-controlling stakes) or have effective control over a company or other legal entity, either directly or through a third party. The main objective of the CRBO is to organize and keep up-to-date the identification and information regarding the beneficial owners of the covered entities in order to enhance transparency in business relationships and compliance with the duties for the prevention and combat of money laundering and terrorist financing.

14. The common ownership topic may re-ignite the discussion about whether jurisdiction should be expanded to the acquisition of minority shareholdings or, at least, require some amendments to the information provided in the Notification Form in order to include more information on common ownership that could be accounted for in the competitive assessment of a given merger. Notwithstanding, this issue and the tools to address it in the competitive assessment of merger control are already foreseen, at least to some extent, in the AdC's Horizontal Merger Guidelines.

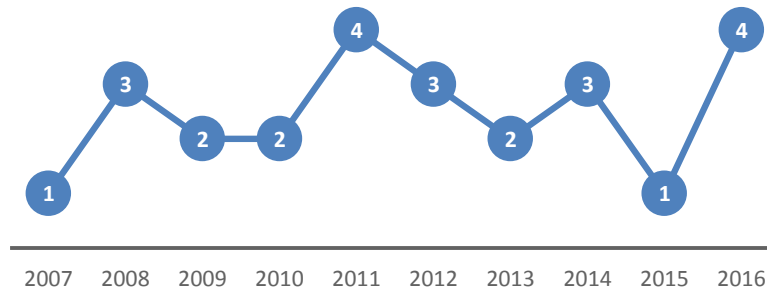
⁸ See decision on Ccent. 06/2008 – EDP/EDIA about the effect of Iberdrola's internalisation of the profits linked to its minority shareholding in EDP on the incentives to independently run two EDP hydropower plants according to the commitments undertaken by EDP.

⁹ In this context, it may be justified to adjust the calculation formula of the HHI and the Delta, for example.

3. Acquisitions by investments funds in Portugal

15. The acquisitions by large Investment Funds has been a trend in the past years in Portugal.

Figure 1. Number of Acquisitions by Investment Funds notified to the AdC



Source: AdC

16. The acquisitions carried out by private equity funds in the past years could be perceived as a trend somehow linked with the financial crisis. Indeed, in May 2011, the Portuguese Government on the one hand, and the European Commission on behalf of the Eurogroup, the European Central Bank (ECB) and the International Monetary Fund (IMF) on the other, signed the Economic Adjustment Programme for Portugal, the so-called bailout program on financial assistance.

17. In a context of constrained access-to-capital, the Portuguese economy reached for alternative funding options. Financial investors accounted for a relevant proportion of M&A deals during those years and still do in the aftermath of the financial crisis.

18. From the analysis of several merger in Portugal involving acquisition by private equity funds, it is often the case that these funds acquired companies in financial distress.

19. In the merger control remit, the AdC has no record of assessing common ownership in competing firms by institutional investors in concentrated markets. However, there is experience in analysing the issue of common ownership in acquisitions by companies other than institutional investors. Given that the economic reasoning and tools for assessing these mergers is identical to those applied to merger's acquisitions by institutional funds, we detail our methodology below.

4. Adjusting the toolbox of merger control to common ownership

20. Measuring the impact of common ownership and using competition policy to address any potential competition concerns arising from common ownership can be challenging and some questions have been put forward regarding the usefulness and feasibility of using modified Herfindahl-Hirschman ("MHHI") or price pressure indices ("PPI").

21. In Portugal, a recent case brought attention to this issue and it was necessary to adjust the quantitative tools foreseen in the AdC Horizontal Merger Guidelines. Although

the case was not linked to private equity funds, it concerned common ownership by large financial firms.

22. The merger entailed the acquisition of the merchant acquiring business of UNICRE by SIBS (payment services holding). The assessment conducted by the AdC concluded that the merger could strengthen barriers to entry and competition in the market, and ultimately lead to a monopoly in the Portuguese payment system and cause serious harm to merchants and final consumers.

23. The merger could weaken the conditions for competitive merchant service charges and entail significant costs for merchants to accept payment cards. Consumers could also be negatively affected by a reduction in the number of merchants accepting card payments.

24. Unicre's acquiring business, under the brand name "Redunicre", is the largest card payment acquirer in Portugal, with a market share four times larger than its closest competitor, Netcaixa, owned by Caixa Geral de Depósitos (one of the main banks in Portugal).

25. The market is characterised by a high degree of common ownership as shown in Table 1: 63% of SIBS's share capital and 94% of Unicre's share capitals are owned by the same 4 banks and 100% of Unicre's share capital and 73% of SIBS's share capital are owned by the same set of banks.

Table 1. Ownership Structure of SIBS and Unicre

	Unicre	SIBS
CGD	0.0%	21.6%
BCP	31.7%	21.5%
NB	17.5%	8.0%
BST	21.5%	15.0%
BPI	20.7%	15.0%
CCAM	0.4%	0.5%
OUTROS	7.8%	18.5%

Source: SIBS and UNICRE Annual Reports, 2015.

26. As Caixa Geral de Depósitos (CGD) is a shareholder of SIBS, as a result of the merger, CGD would acquire an indirect stake in the merchant acquiring business of UNICRE, which would lead to an alignment of incentives and behaviour of the two main competitors in the market and thus soften competition in the market.

27. Given that formally, the notifying parties did not overlap, for example, in the market of merchant acquiring of credit cards, the calculation of the unadjusted HHI would entail a Delta of zero.

28. The modified HHI, however, is a useful tool for a first screening of the change of in firms' incentives brought about by the merger as a result of the acquisition by CGD of a minority direct shareholding in its main rival in the market of merchant acquiring of credit cards.

29. The calculation of the modified HHI was based on Azar *et. al* (2016). This model takes into consideration the fact that companies' managers take into account the profits of the shareholders and also the profits of the rival companies in which they have shareholdings.

30. The model is flexible enough to incorporate cross-shareholdings where a company owns shares in a rival company in the market and/or common shareholdings, where companies outside the relevant market (e.g. investment funds) own shares in two or more companies in the relevant market.

31. Moreover, the model also allows to differentiate between financial stakes and controlling stakes (e.g., company A has a 50% financial interest in company B but has sole control over the company through a shareholders' agreement).

32. Thus, the objective function of each company in the market depends, not only on its own strategies but also on the effects that such strategies have in the profits of its rivals (to the extent of the common and/or the cross shareholdings).

33. In other words, each company internalizes the externalities generated by an aggressive competitive strategy on the rivals in which it has a shareholding (or in which its shareholders also have shareholdings).

34. Mathematically, the Modified HHI is given by:

$$MHHI = \sum_j \sum_k \frac{\sum_i \gamma_{ij} \beta_{ik}}{\sum_i \gamma_{ij} \beta_{ij}} s_j s_k$$

Where:

γ_{ij} is the ultimate voting shareholding (direct + indirect) of shareholder i in company j .

β_{ij} is the ultimate financial shareholding (direct + indirect) of shareholder i in company j .

35. In the SIBS/Redunicre case, the MHHI both before and after the merger more accurately reflected the degree of concentration in the market given the widespread cross and common shareholdings. It also more accurately reflected the softening of the incentives to compete stemming from the change in shareholding structures of market participants (namely by CGD).

36. The AdC also quantified the merger's impact on prices and welfare. An equilibrium industry model was built to account for 3 central features of the market: the fact that the payment cards system is a two sided platform; the fact that acquiring and issuing - on the one hand - and processing, on the other hand, are vertically related activities; and the high degree of common ownership as acquirers and the processor are owned by the issuers (i.e. banks). Common ownership was modelled through ownership matrices. Shareholders were assumed to maximise the income associated with their portfolio of shareholdings and managers were assumed to maximise their objective function, given by the sum of the value of their shareholders, weighted by their shareholding.

37. Upon considering all the quantitative and qualitative information, the main competition concerns identified by the AdC were the following:

- Horizontal (negative) effects that followed from the increase in the concentration level in the merchant acquiring markets given that CGD was acquiring a direct interest in the merchant acquiring business of SIBS. This effect would align the incentives and behaviour of the two closest competitors in the market, thereby restricting competition.

- Vertical effects of market foreclosure that hindered the ability of current competitors and potential entrants to compete with SIBS' acquiring and processing businesses.

38. The investigation concluded that there were significant barriers to entry that would impede alternative players from entering the national processing and merchant acquiring markets in sufficient scope and magnitude to counteract the anti-competitive effects of the merger. The AdC concluded that such barriers to entry would be strengthened by the merger.

39. Ultimately, the AdC issued a statement of objections and the parties decided to withdraw the merger.

5. Conclusion

40. Common ownership raises important questions regarding competition law enforcement. While the empirical literature in the topic is far from settled, it seems clear that, at least in some circumstances, common ownership can soften the incentives to compete and raise concerns with tacit collusion.

41. The AdC has no jurisdiction on acquisitions of non-controlling stakes. Nonetheless, both the AdC's Horizontal Merger Guidelines and the Merger Notification Form account for minority shareholdings, setting the grounds for addressing common ownership. The AdC also has decisional practice that is illustrative of the adjustments needed to account for this important market feature.

42. The literature and debate regarding common ownership, and its impact on competition, may re-ignite the discussion about whether jurisdiction should be expanded to the acquisition of minority shareholdings, and may potentially call for a review of the Portuguese legal framework on merger control in that regard.