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

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

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1. Introduction

1. German merger control law contains provisions that address the acquisition of minority shareholdings. Furthermore, minority shareholdings may be subject to review under provisions addressing anticompetitive agreements. German law does not contain specific rules on common ownership by institutional investors. However, in certain circumstances, the simultaneous ownership of shares in competing firms by institutional investors may raise competition concerns. The German Monopolies Commission dealt with this issue in its Main Report in 2016.

2. After a brief overview of the provisions of the German Competition Act (Act against Restraints of Competition – GWB) concerning minority shareholdings (section II) and the acquisition of shares by credit institutions, financial institutions or insurance companies (section III), this contribution summarizes the main findings of the Monopolies Commission on the competitive importance of institutional investors (section IV).

2. Minority shareholdings in German merger control law

3. Under German competition law, the acquisition of minority shareholdings may be subject to merger control if the thresholds for notification are met and no exception applies.[1] Transactions that might be relevant in the context of minority shareholdings are: 1) the acquisition of at least 25% of the shares (capital or voting rights) in another undertaking. If several undertakings simultaneously or successively acquire shares in another undertaking, this shall also be deemed to constitute a concentration between the undertakings concerned with respect to those markets on which the other undertaking operates;[2] 2) any other combination of undertakings enabling one or several undertakings to exercise directly or indirectly a material competitive influence on another undertaking.[3] In exceptional cases, the acquisition of minority shareholdings may also, together with special rights, confer control on another undertaking.[4]

4. While the acquisition of at least 25% of the shares is quite straightforward, the criterion of a material competitive influence requires further clarification: This provision was introduced into German competition law in 1990 to prevent undertakings from circumventing merger control by structuring acquisitions so that participations below

[1] See Section 35 GWB. An unofficial English version of the GWB is available at https://www.gesetze-im-internet.de/englisch_gwb/index.html.

[2] Section 37 (1) No. 3 lit. b GWB

[3] Section 37 (1) No. 4 GWB

[4] Section 37 (1) No. 2 GWB. The provision corresponds to Article 3 (1) lit. b EC Merger Control Regulation. In that regard, a minority shareholding alone does not suffice to acquire control. Rather, e.g. rights or contracts must confer decisive influence on the target to enable the acquirer to decide upon fundamental questions of competitive relevance concerning the target.

25% would be acquired but coupled with special rights with respect to the target undertaking.

5. A material competitive influence on another undertaking may exist due to any kind of link between two or more undertakings that allows the acquiring party to influence the competitive behaviour of the target in such a way that it is likely to reduce competition between the undertakings, to the degree that they will no longer act independently on the market. For a material competitive influence, it may also suffice for the target to adapt its competitive behaviour to the interests of the acquirer. A material competitive influence may also arise from agreements on pre-emption rights, sales strategies and financial structures, as well as from legal possibilities to exert influence, such as the right to be consulted, information and disclosure rights and, not least, the right to appoint representatives to the management bodies of the target company. Personal interlocks in the form of having the same persons on the management boards of both companies may also lead to a material competitive influence where these persons can exercise a strategic influence. A further possibility is the transfer of entrepreneurial responsibility for certain sub-divisions of the company. Decisive in all cases is the factual possibility of the acquirer to exercise a strategic influence.

3. Passive financial investments of credit institutions

6. In principle, the reasons why an undertaking plans to acquire shares in another undertaking are not a decisive factor for the application of German competition law. An exception applies in the context of the so-called banking clause,[5] which exempts the acquisition of shares in an undertaking from merger control if the acquirer is a credit or financial institution or an insurance company that intends to resell the shares within a period of one year and does not exercise the voting rights attached to the shares.[6] The purpose of this rule is to facilitate the transactions and dealing in securities by financial service providers. By acquiring shares within the context of their general operations, these companies do not normally pursue any objectives which would be relevant to competition. The time limit of one year may, upon request, be extended by the Bundeskartellamt if it can be shown that the resale was not reasonably possible within this period. If the resale does not take place within one year and the time limit is not extended, the acquisition is subject to merger control. The same applies if the original plan to resell is abandoned or if the voting rights attached to the shares are exercised.

4. Non-controlling minority shareholdings of institutional investors – the analysis of the Monopolies Commission

7. Institutional investors are specialized financial institutions that invest funds on behalf of a wide range of investors with the goal of maximizing returns at a reasonable risk. Institutional investors include insurance companies, asset managers, investment funds and pension funds, as well as private equity firms, banks, hedge funds, funds of funds and state funds. Institutional investors can hold highly diversified minority interests in a variety of companies around the world in various economic sectors in order to

[5] Section 37 (3) GWB.

[6] This rule largely corresponds with Article 3 (5) lit.a of Council Regulation (EC) No 139/04.

achieve a desired balance between risk and return. Despite the small shares (often less than one percent of a company), institutional investors are often the largest single investor because the remaining shares are fragmented among many shareholders.[7]

8. German competition law does not contain specific legal provisions on the acquisition of non-controlling minority shareholdings of institutional investors, *i.e.* the general merger control rules mentioned in section II above apply.

9. Minority shareholdings of institutional investors generally do not meet the thresholds for merger control. They have been attributed minor importance in competition law enforcement so far, because it was generally assumed that portfolio investments did not have a strategic impact and thus anti-competiive effects. Institutional investors are not active in the same markets as their portfolio companies, neither upstream nor downstream. This distinguishes institutional investors from shareholders with operationally strategic shares and, theoretically, excludes distortive effects on competition. However, the possession of shares by institutional investors in several companies active in the same sector could reduce incentives to compete in the markets where the portfolio companies are active.

10. The Monopolies Commission[8] addressed the issue of common ownership of shares by institutional investors in its Main Report of 2016.[9] As a major contribution to the debate in Germany, the report will be presented in more detail below. The Monopolies Commission believes that participations of institutional investors in portfolio companies operating in the same economic sector have a major distorting potential on competition, despite small shares and a (formal) limited possibility to influence strategic decisions. The competitive effect of indirect horizontal ties may be aggravated by additional factors, such as common interests among institutional investors and institutionalized voting procedures.

4.1. Incentives to reduce competition

11. If an investor holds shares in several companies operating in the same market, he has an interest in maximizing the return that all the shares generate. An intense competition between his portfolio companies could be undesirable, as the prices and profit margins of all his portfolio companies could fall.[10] For this reason, it could be both

[7] Paragraph 670.

[8] The Monopolies Commission is an independent advisory body in the areas of competition policy and regulation. It has the statutory responsibility to monitor effective competition in Germany in general and in specific sectors of industry. Pursuant to Section 44(1) GWB, every two years the Commission submits a Report (Hauptgutachten) to the Federal Minister for Economic Affairs and Energy.

[9] Monopolkommission, „Wettbewerb 2016. Einundzwanzigstes Hauptgutachten der Monopolkommission gemäß § 44 Abs. 1 Satz 1 GWB, at: http://www.monopolkommission.de/images/HG21/HGXXI_Gesamt.pdf; 667 et seq.

An English translation can be found at: http://www.monopolkommission.de/images/HG21/Main_Report_XXI_Institutional_investors.pdf .

[10] The Monopolies Commission refers to empirical investigations that concluded that common ownership by institutional investors led to price increases: Azar/Schmalz/Tecu, "Anti-Competitive Effects of Common Ownership", Ross School of Business Working Paper No. 1235 (2015); Azar/Raina/Schmalz,"Ultimate Ownership and Bank Competition" (2016).

in the interest of the portfolio companies and in the interest of the investor to keep the profit margins above the competitive level by reducing competition in the market.

12. If several institutional investors hold shares in several companies operating in the same sector, the risk of eliminating competition between the portfolio companies is even higher because investors could have a common interest in reducing competition in the sector. This could be even more true, if there are ties between large institutional investors.[11]

13. Institutional investors could even coordinate their voting behaviour to influence their portfolio companies. Institutional investors increasingly use consultancies, so-called proxy advisors, to exercise their right to vote. These consultancies are responsible for preparing shareholders meetings, as well as voting recommendations for these meetings, which are generally followed by institutional investors.[12]

14. There are, however, also factors which might mitigate the anti-competitive effects of common ownership by institutional investors:[13] a) Investors also have a long-term interest in competition-induced investments and in efficiency improvements in the portfolio companies; b) non-diversified investors are often interested in fostering the competitive potential of their portfolio companies; c) ultimately, the presence of overlapping ownership structures can lead to a reduction in the diversification potential.

15. According to the Monopolies Commission, the potential of reducing competition in a given market is by no means a sufficient argument for the assumption of distortive effects. The extent to which institutional investors have the possibility to enforce their interests against the management of the portfolio companies and/or the extent to which corporate ties allow or facilitate parallel behaviour, must also be considered.

4.2. Possibility of exercising a strategic influence

16. The first possibility of influence is the exercise of voting rights. Institutional investors could influence strategic decisions even with small shares, for example, through a blocking minority of 25%. Rather than the mere amount of shares held by institutional investors, the possibility of strategic influence is determined by the distribution of the other voting rights and their effective excercise. The Monopolies Commission notes that in 2015, for example, the presence rate at the annual general meetings of the DAX-30 companies was below 55%, and thus 28% of the voting rights were sufficient for a simple majority.

17. In addition to the exercise of voting rights, also the membership of the Supervisory Board, the pressure through potential share selling and the attempt to force the management to make changes might affect the strategic behaviour of a company. In particular, if portfolio companies are aware of the fact that in the future they may be dependent on the current or other institutional investors to cover their financing requirements, the actual size of the investor's share may not be that relevant for their assertiveness.

[11] Paragraph 673.

[12] Paragraph 680.

[13] Paragraph 674.

4.3. Need for action

18. The Monopolies Commission carried out an empirical analysis to assess the actual existence of problematic constellations of indirect horizontal minority shares held by institutional investors in Germany and Europe.[14] From the data emerges that many institutional investors hold shares in several portfolio companies in one economic sector. This is particularly evident in the manufacturing industry in the sectors "Manufacture of data-processing equipment, optical and electronic equipment" and "Manufacture of machinery and vehicles". According to the Monopolies Commission, the empirical analysis of the distribution of portfolio companies among investors and economic sectors provides an initial indication of the presence of potentially problematic investment constellations. The analysis cannot answer the question of whether these constellations actually distort competition in these sectors, but it could provide a first basis for action.

19. The Monopolies Commission supports the European Commission's view that for the time being an extension of the scope of the EU Merger Regulation[15] to non-controlling minority shareholdings between horizontally and vertically linked companies might not be proportionate in view of the limited number of cases with potential harm to competition.[16] However, with regard to common ownership by institutional investors, there may be important arguments for more stringent control: Given the fact that this phenomenon is becoming omnipresent and increasingly relevant from a competition policy perspective, this issue should be discussed more intensively in connection with the further development of the EU Merger Regulation.[17] In any event, the Monopolies Commission still sees a need for clarification before making any concrete recommendation for action. In particular, it mentions the need for sector-specific studies on corporate ties via institutional investors and the importance of shareholders with competitive interests, as well as on the effects of common ownership on the market results.[18]

5. Possible solutions

20. Minority shares by institutional investors could be taken into account when measuring market concentration and thus the potential for competitive problems. The Herfindahl Hirschman Index (HHI) is frequently used to measure market concentration. Several scientific studies consider the MHHI (Modified HHI) or GHHI (Generalized HHI) a better alternative to the usual HHI, because these modified indexes also allow to take into account anti-competitive incentives resulting from minority participation and cross-participation.[19] However, the calculation of these indexes requires information from

[14] Paragraph 683 et seq.

[15] Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation). Official Journal L 24, 29.01.2004, p. 1-22

[16] http://ec.europa.eu/competition/publications/reports/KD0416839ENN.pdf

[17] Paragraph 666, 689.

[18] Paragraph 690.

[19] There are slight differences in the definition of these indexes. The GHHI includes risks with respect to co-ownership and cross-shareholdings. The MHHI either measures the same as the GHHI or only the risks resulting from co-ownership. See Azar/Schmalz/Tecu (2016).

downstream companies that are not direct parties to the merger.[20] The use of the MHHI / GHHI for competition law enforcement could also be too premature, given that the literature on this issue is still in the initial phase.[21]

21. The current literature on common ownership by institutional investors also calls for new control mechanisms. Strict transparency requirements could be introduced, as well as a systematic merger control enforcement that takes into account investments in portfolio companies. Since investors could be presumed as having equal interests up to a certain degree and since there could be ties between diversified investors, the Monopolies Commission suggests, for example, to aggregate the shares of all institutional investors involved in a company that are equally diversified within the industry, if such equal interest can be assumed. This would be similar to an actual form of minority control, in which several minority shareholders effectively control a company through joint action.[22] From a merger control perspective, common ownership by institutional investors could be regarded as a passive form of strategic influence, where even small shares could allow investors to have a decisive impact on their portfolio companies' decisions.

22. The increasing importance of this topic shows that there is a need for further discussion on whether and how competition law should be further developed to address it.

[20] Page, W. & Woodbury J.: Paper Trail: Working Papers and Recent Scholarship (2016), p. 5.

[21] Page/Woodbury; Baker (2016); Baker (2016); O'Brien/Waehrer "The Competitive Effects of Common Ownership: We Know Less than We Think" (2017).

[22] Paragraph 678 of the Report. This approach is not new. Section 37 (1) No. 4 GWB is also applicable if the significant competitive impact can be exercised jointly by several companies (see section II). According to the case law, joint influence presupposes a common interest which goes beyond the joint participation as such. Companies must cooperate on the basis of an agreement or in any other way, which would secure a joint influence (OLG Düsseldorf, decision of 31.1.2001, Kart5/00 (V), WuW/E DE - R 647, 654 – OTZ). Actual circumstances may be sufficient to justify a joint possibility of influence (BGH, decision of 22.6.1981, KVR 7/80, WuW/E 1810,1811 – Transportbeton Sauerland).