Simpson Thacher

Memorandum

Do Mutual Fund Managers' Horizontal Shareholdings in Competing Firms Create Antitrust Risks?

November 18, 2015

Two recent academic papers, a law review article and an econometric study, hypothesize that horizontal shareholdings—a term that refers to the practice of mutual fund complexes owning significant shares in corporations that compete against each other, particularly in concentrated industries—may violate U.S. antitrust laws. For example, under the view presented in these papers, antitrust issues could arise when institutional investors hold even relatively small (5-10%) ownership stakes in competitors in an industry with few (generally fewer than five) major players. These recent papers invite regulatory agencies and the private plaintiffs' bar to bring antitrust claims against institutional investors who engage in horizontal shareholdings. Indeed, the Department of Justice has initiated an investigation into possible collusion in the airline industry, and, it was recently reported, sought discovery of communications between the airlines and firms that advise mutual funds.

In a law review article published online this past summer and forthcoming in the Harvard Law Review, Harvard Law School Professor Einer Elhauge argues that shareholdings in competing companies should be subject to scrutiny under Section 7 of the Clayton Act, which prohibits the acquisition of stock or assets where "the effect of such acquisition may be to substantially lessen competition, or to tend to create a monopoly."[1] According to Professor Elhauge, horizontal shareholdings reduce the incentives of portfolio companies to undercut each other on price and compete for market share because such behavior is contrary to the interests of the companies' shareholders (to maximize profits across all portfolio companies). He argues that the dilution in incentives occurs "even if their respective management never communicate or coordinate with each other."

Professor Elhauge relies on a recently-published working paper by economists José Azar, Martin Schmalz,

[1] 15 U.S.C. § 18.

and Isabel Tecu, which concludes that common ownership in the airline industry has resulted in higher ticket prices. Using econometric analysis and a modified Herfindahl-Hirschman Index designed to capture the effects of common ownership, these economists claim that horizontal shareholding of airlines has resulted in presumptively anticompetitive concentration levels and price increases of 3-5% on the average U.S. airline route than would be the case in the absence of such horizontal shareholdings. Notably, they acknowledge that their work "does not contribute direct evidence of the mechanism that implements the incentives" that supposedly cause higher average prices.

Legal Framework Under the Clayton Act

Potential liability under Section 7 of the Clayton Act most commonly arises when an entity acquires the whole, or any part, of the stock or assets of a direct competitor. Because Section 7 does not apply to stock purchases that are solely for investment purpose (a provision known as the "passive investor defense"), acquisitions by mutual fund complexes and other institutional investors have generally not been subject to antitrust scrutiny. However, investors invoking the passive investor defense bear the burden of proving a lack of control over portfolio investments. The concept of "control" is not clearly defined and requires a case-by-case analysis; however, the defense is generally unavailable if: (i) the investor acquires or attempts to acquire a sufficient stake to give it control; (ii) seeks to influence business decisions; (iii) appoints members to the portfolio company's board of directors; or (iv) has access to non-public information.

Although rare, application of Section 7 to horizontal shareholding by an investment firm not otherwise controlling at least one of two direct competitors is not entirely unprecedented. For example, in 1974 the Department of Justice brought an enforcement action challenging an investment company's minority holdings in competing brick companies.[2] Together, the brick companies held a market share of about 50%. The Department of Justice argued that the passive investor defense was unavailable because the investment company appointed members to the brick companies' boards of directors and used its voting rights to influence management and policy decisions. Before a decision could be reached, one of the portfolio brick companies rendered the action moot by voluntarily exiting the market.

The recent literature takes this argument a step further, and many would say goes a bridge too far. Professor Elhauge would lower the burden for regulators and private plaintiffs by arguing that horizontal shareholdings are subject to antitrust scrutiny even absent significant voting and governance rights. First, he argues that "passive" investors engage in behind-the-scenes "active ownership," such that the passive investor defense should not apply. Second, and most novel of all, Professor Elhauge claims that the mere fact of horizontal shareholding alone can restrain competition by inducing portfolio companies to compete less aggressively or by facilitating coordinated action. He interprets the passive investor defense under Section 7 to require not only that a purchase of stock be solely for investment, but also that such

[2] *See United States v. Cleveland Trust*, 392 F.Supp. 699 (N.D. Ohio 1974).

shareholding not to bring about a substantial lessening of competition. Thus, all a regulator or plaintiff needs to establish, according to Professor Elhauge, is evidence (in the form of an econometric study) that horizontal shareholdings actually raised prices in a relevant market.

Will the Recent Novel Theory and Economic Study Gain Traction?

It is too early to predict whether U.S. regulators or the plaintiffs' bar will test Professor Elhauge's novel interpretation of the passive investor defense in court or rely on econometric studies similar to that presented in the Azar, Schmalz, and Tecu working paper. The legal theory under Section 7 of the Clayton Act appears fundamentally misconceived given the wording of the passive investor exception: "This section shall not apply to persons purchasing such stock solely for investment ***and not using the same*** by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition."[3] In contrast to the two-prong passive investor test posited by Professor Elhauge, the statutory language only requires that a shareholder not affirmatively ***use*** shares to bring about anticompetitive effects. That is a far cry from imposing liability on mutual fund complexes or their advisers simply because an alleged effect of otherwise passive shareholdings is to increase prices in a concentrated industry. Beyond this legal flaw, the econometric study described in the economists' working paper is subject to numerous potential criticisms and says nothing about the effect of horizontal shareholdings in industries other than the airline industry.

More likely, the U.S. regulators and the private plaintiffs' bar will, at least for now, favor exploration of more traditional Sherman Section 1 conspiracy and Clayton Act Section 7 theories, including whether competitors have used communications with fund advisers to facilitate collusion and whether mutual fund shareholdings were, in fact, not acquired solely for investment purposes. Indeed, recent media reports concerning the Department of Justice investigation of the major airlines suggest that Justice is focused on a more traditional line of inquiry under the Sherman Act. Mutual fund advisers, meanwhile, should review and consider updating their antitrust compliance policies and heighten employee awareness of the potential antitrust risks that may arise from both traditional and possibly novel approaches to horizontal shareholdings in competitors in concentrated industries.

[3] 15 U.S.C. § 18.

For further information, please contact one of the following members of the Firm's Antitrust or Registered Funds practices.

ANTITRUST

Peter Thomas
+1-212-636-5535
pthomas@stblaw.com

Sara M. Clingan
+1-202-0636-5563
sara.clingan@stblaw.com

REGISTERED FUNDS

Rajib Chanda
+1-202-636-5543
rajib.chanda@stblaw.com

Christopher P. Healey
+1-202-636-5879
christopher.healey@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-Gil, Jung-Gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000