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The Conundrum of Common Ownership

Law Working Paper N° 500/2020

April 2020

Jennifer G. Hill

Monash University and ECGI

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I would like to thank participants at the 2018 Global Corporate Governance Conference (GCGC) at Harvard Law School and participants at the NUS/Vanderbilt Law School Comparative Corporate Law & Governance: Asian and Global Perspectives 2019 conference in Singapore for helpful comments in relation to this paper. Thanks also go to Tim Bowley, Brent Fisse, Rob Nichols and Rebecca Wexler for valuable suggestions and to Yesha Yadav for prompting my initial interest in the corporate governance implications of common ownership. Finally, I would like to thank Clare Hall, Cambridge University, where I was a Visiting Fellow while undertaking research for this article. Thanks also go to Mitheran Selvendran for excellent research assistance.

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Abstract

The common ownership debate has become one of the most contentious issues in corporate law today. This debate is a by-product of major changes to capital market ownership structure, which have triggered concerns about the rise of institutional investors, the growth of index investing, and the rapid concentration of ownership in major international financial markets.

Common ownership theory focuses on concerns about the incentives of large financial institutions holding widely diversified portfolios of shares in competing companies within a particular economic sector. Proponents of the common ownership theory argue that, even where institutional investors have relatively small ownership stakes, their collective holdings in competing companies produce anticompetitive effects. Other scholars, however, have challenged both common ownership theory and its regulatory prescriptions. Although common ownership theory began in the United States, it is now being discussed around the world.

This Article examines three conflicting narratives that emerge in this literature concerning institutional investors and common ownership theory. The Article seeks to position these narratives within the context of the rising influence of institutional investors since the early 1990s and its relation to major international corporate governance developments. It analyzes aspects of common ownership theory in light of these contemporary corporate governance developments, and argues that drawing regulatory and policy conclusions from the current body of conflicting empirical findings on the effects of common ownership is premature.

Keywords: shareholding, concentrated ownership, portfolio diversification, common ownership, institutional investors, index funds, passive investors, antitrust, regulation.

JEL Classifications: D21, D43, G30, G32, G34, K21, K22, L13, L21, L22.

Jennifer G. Hill
Professor and Bob Baxt AO Chair in Corporate and Commercial Law
Monash University, Faculty of Law
Building 15, Clayton Campus
Clayton, Victoria 3800, Australia
phone: +61 3 9905 3838
e-mail: jennifer.hill@monash.edu

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Jennifer G Hill[*]

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ABSTRACT

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[*] Jennifer Hill is the Bob Baxt AO Chair in Corporate and Commercial Law, Monash University Faculty of Law, Melbourne, Australia; Research Member of the European Corporate Governance Institute (ECGI). I would like to thank participants at the 2018 Global Corporate Governance Conference (GCGC) at Harvard Law School and participants at the NUS/Vanderbilt Law School Comparative Corporate Law & Governance: Asian and Global Perspectives 2019 conference in Singapore for helpful comments in relation to this paper. Thanks also go to Tim Bowley, Brent Fisse, Rob Nichols and Rebecca Wexler for valuable suggestions and to Yesha Yadav for prompting my initial interest in the corporate governance implications of common ownership. Finally, I would like to thank Clare Hall, Cambridge University, where I was a Visiting Fellow while undertaking research for this article. Thanks also go to Mitheran Selvendran for excellent research assistance.

developments, and argues that drawing regulatory and policy conclusions from the current body of conflicting empirical findings on the effects of common ownership is premature.

I. INTRODUCTION

One of the most contentious issues in corporate law today is the common ownership debate. This debate is a by-product of major changes to capital market structure over the last few decades. It reflects concern about the rise of institutional investors, the growth of index investing, and increasing ownership concentration in financial markets.[1]

"Common ownership" (which is sometimes used synonymously with the terms "horizontal shareholding" or "overlapping shareholding"),[2] describes the situation where large financial institutions with widely diversified portfolios own shares in competing companies within a particular economic sector.[3] A number of scholars (described in this Article as "anti-common ownership scholars") have argued that, even where these institutions have relatively small ownership stakes, their collective holdings in competing companies produce anticompetitive effects in a range of corporate governance contexts, such as M&A[4] and executive compensation.[5] The basis for this claim is that, in such circumstances, the institutions are interested in the financial performance of their portfolios as a whole, rather than the performance of individual companies in that sector.[6]

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1 *See, e.g.*, Eric Posner et al., *A Monopoly Trump Can Pop*, N.Y. TIMES, Dec. 7, 2016, at A29; Eric Posner & E. Glen Weyl, *Mutual Funds' Dark Side: Why Airlines and Other Industries Keep Prices Too High*, SLATE, Apr. 16, 2015.

2 *Cf* Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 4, 2018), 4-6, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812.

3 *See*, *e.g*., José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).

4 *See, e.g.*, Miguel Antón et al., *Does Common Ownership Increase Incentives for Mergers and Acquisitions?*, CPI ANTITRUST CHRONICLE, May 2019; Miguel Antón et al., *Beyond the Target: M&A Decisions and Rival Ownership* (Jan. 19, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3226390.

5 *See, e.g.*, Einer Elhauge, *How Horizontal Shareholding Harms Our Economy – And Why Antitrust Law Can Fix It* (Aug. 2, 2019), 8-9 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293822.

6 *See, e.g.*, José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016).

Although the common ownership debate began in the United States, it is now attracting attention around the world.[7] For example, European intergovernmental and regulatory organizations have focused on the debate,[8] which also has clear relevance to certain jurisdictions in the Asia-Pacific region.[9] This is particularly true of Australia, given the distinctive role and large size of superannuation/pension funds in Australian capital markets[10] and the concentration of certain industries, such as the banking and finance sector.[11]

The aim of this Article is to contextualize the common ownership theory within a broad range of international corporate governance developments relating to institutional investment since the early 1990s. The structure of the Article is as follows. Part II discusses the impact on legal scholarship of the common ownership theory, which commenced in the field of financial economics. Part III examines three possible narratives that exist in the literature relating to institutional investors and common ownership. Part IV analyzes certain aspects of the common ownership theory in the light of contemporary corporate governance developments and debate, and Part V concludes the Article and argues that drawing regulatory and policy conclusions from current mixed empirical evidence is premature.

II. LAW'S DISCOVERY OF AN "ECONOMIC BLOCKBUSTER"

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7 See Brooke Fox & Robin Wigglesworth, *Common Ownership of Shares Faces Regulatory Scrutiny*, FINANCIAL TIMES, Jan. 22, 2019.

8 *See, e.g.*, Organisation for Economic Co-operation and Development, *Common Ownership by Institutional Investors and its Impact on Competition*, Background Note by the Secretariat, Dec. 5-6, 2017 (available at https://one.oecd.org/document/DAF/COMP(2017)10/en/pdf); Monopolkommission, *Common Ownership: Excerpt from Ch II of the XXII Biennial Report of the Monopolies Commission* (2018) (available at https://www.monopolkommission.de/images/HG22/Main_Report_XXII_Common_Ownership.pdf); .

9 *See, e.g.*, Ben Charoenwong, *The Cost of Common Ownership to the Singapore Government*, THE STARTUP, May 20, 2019.

10 See Rob Nichols & Deniz Kayis, *Common Corporate Owners, Concerted Corporate Actions?* (2019, Working Paper, on file with the author).

11 See Jennifer G. Hill, *Why Did Australia Fare So Well in the Global Financial Crisis?*, *in* Eilis Ferran et al., THE REGULATORY AFTERMATH OF THE GLOBAL FINANCIAL CRISIS 203, 291-92 (2012).

At the turn of the twenty-first century, a team of financial economists, Professor Rafael La Porta et al., postulated that "law matters" when it comes to the structure of capital markets.[12] The hypothesis claimed that jurisdictions with high levels of legal protection for minority shareholders would develop deep liquid capital markets like those in the United States and the United Kingdom. The "law matters" hypothesis had significant policy implications for regulation and law reform,[13] and proved highly influential in both economics and law.[14]

Almost twenty years on, recent scholarship concerning common ownership provides a strong counterpoint to the "law matters" hypothesis in terms of its policy implications for capital market regulation. According to anti-common ownership scholars, the problem today is that fund flows to deep capital markets occur via a small number of increasingly powerful financial intermediaries with highly diversified portfolios. [15]

Like the "law matters" hypothesis, the common ownership theory originated in economic literature, but subsequently emerged in legal scholarship, where it has had a major impact. In a high profile 2016 *Harvard Law Review* article, Professor Einer Elhauge described the argument that common ownership has anticompetitive effects as a recently exposed "economic blockbuster".[16] Anti-common ownership scholars have referred to the rise of institutional

12 *See, e.g.*, Rafael La Porta et al., *Law and Finance*, 106 J. POLITICAL ECONOMY 1113 (1998); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

13 The "law matters" hypothesis also had strong normative overtones, viewing the legal protections offered by common law legal systems as superior to those found in civil law legal systems. See David A. Skeel Jnr, *Corporate Anatomy Lessons*, 113 YALE L.J. 1519, 1544-45 (2004).

14 *See, e.g.*, Steve Kaplan & Luigi Zingales, *How "Law and Finance" Transformed Scholarship,* Debate, , CHICAGO BOOTH REVIEW, Mar. 5, 2014. Nonetheless, many legal scholars were extremely critical of certain aspects of the "law matters" hypothesis. For an overview of this criticism, *see* Jennifer G. Hill, *The Persistent Debate About Convergence in Comparative Corporate Governance*, 27 SYD. L. REV. 743 (2005).

15 *See* José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1514, fn 2 (2018) (citing Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. AND POLITICS 298 (2017)).

16 *See* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1267 (2016). *See also* Einer Elhauge, *The Growing Problem of Horizontal Shareholding*, ANTITRUST CHRONICLE (Jun. 2017); Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 2018), (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812).

investors as "[t]he great, but mostly unknown, antitrust story of our time",[17] and "a smoking gun".[18]

There have been major changes to capital market structure over the last few decades, and these changes lie at the heart of the common ownership theory. Today, the dominant shareholders of public companies in many, but by no means all,[19] jurisdictions are institutional intermediaries. The growth in financial intermediation in savings and investment decisions was foreseen from at least the 1970s by commentators, such as Peter Drucker[20] and Professor Robert Clark.[21] As anti-common ownership scholars have noted, however, financial intermediation investment channels are now highly concentrated.[22] The alleged culprits behind the common ownership theory are major financial institutions, such as BlackRock, Vanguard, and State Street Global Advisors.[23] A frequently cited statistic is that the combined holdings of these institutions (the

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17 *See* Eric Posner et al., *A Monopoly Trump Can Pop*, N.Y. TIMES, Dec. 7, 2016, A29. See also Eric Posner et al., *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST LAW JOURNAL 669 (2017).

18 Eric Posner & E. Glen Weyl, *Mutual Funds' Dark Side: Why Airlines and Other Industries Keep Prices Too High*, SLATE, Apr. 16, 2015.

19 India, for example, is a case in point. See George S. Geis, "Shareholder Power in India", *in* RESEARCH HANDBOOK OF SHAREHOLDER POWER 592 (Jennifer G. Hill & Randall S. Thomas eds., 2015) (arguing that institutional investor power in India is either static or dwindling).

20 *See* Peter F. Drucker, THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA (1st ed., 1976).

21 Robert C. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561 (1981).

22 *See* José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1514, fn 2 (2018). (citing Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. AND POLITICS 298 (2017)).

23 *See* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1268 (2016). *See also* Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. AND POLITICS 298 (2017).

so-called “Big Three”)[24] constitute the largest investment group in 88 percent of all S&P 500 firms,[25] and this concentration is increasing.[26]

The common ownership theory is linked not only to institutional investors, but also to a particular type of investment—index investing.[27] There has been massive growth in index funds, including both index-based mutual funds and exchange-traded funds (ETFs),[28] which has led some commentators to ask whether index funds are “eating the world”.[29] Index investing, which relies upon wide stock performance diversification,[30] has become the new default investment option for major financial institutions. According to BlackRock, for example, index investing is now a “cornerstone” of modern investment practice.[31]

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24 *See* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029, 2033 (2019); Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. AND POLITICS 298 (2017).

25 *See* José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1514, fn 2 (2018) (citing Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. AND POLITICS 298 (2017)).

26 It has been predicted that, by 2024, index funds will hold more than 50 percent of the US stock market. Jill Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, *University of Pennsylvania Law Review Institute for Law and Economics Research Paper No. 18-12*, May 19, 2019 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3192069) (forthcoming 2019, U. PENN L. REV.).

27 *See, e.g.*, BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017; Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029 (2019).

28 At the end of 2017, assets of US mutual funds and exchange traded funds (ETFs) totalled over $18 trillion, compared with $5.5 trillion nine years earlier. *See* Morningstar, *5 Charts on US Fund Flows That Show the Shift to Passive Investing*, Mar. 13, 2018 (https://www.morningstar.com/blog/2018/03/12/fund-flows-charts.html).

29 Jason Zweig, *Are Index Funds Eating the World?*, WALL ST. J., Aug. 26 , 2016. *See* also Louis Navellier, *The Index Monster that Ate the Stock Market*, SEEKING ALPHA, Sept. 8, 2016.

30 *See* BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 2*ff*.

31 *Id*, 1. *See also* Sarah Krouse et al., *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J., Oct. 24, 2016); Jill Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, *University of Pennsylvania Law Review Institute for Law and Economics Research Paper No. 18-12*, May 19, 2019 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3192069) (forthcoming 2019, U. PENN L. REV.).

Index funds, which have been described as "autopilot portfolios",[32] track stock indices[33] rather than attempting to beat the market.[34] They feature prominently in the literature discussing common ownership; however, it is important to note the implications of the common ownership theory are, in fact, far broader than this form of investing, and also include actively managed funds.[35]

In contrast to the "law matters" hypothesis, which regarded deep capital markets propelled by institutional investment as a desirable corporate governance outcome, anti-common ownership scholars view this form of diversified shareholding across concentrated product markets as deeply problematic. They claim that there is empirical evidence to show that common ownership results in reduced competition and higher consumer prices in certain sectors. The sectors targeted for academic scrutiny to date are the technology, airline, banking and pharmaceutical industries.[36] An influential economics paper by Professor José Azar et al., for example, claims that common ownership by the largest institutional investors in the US airline sector resulted in reduced competition and higher airline ticket prices for customers.[37] Yet, according to Elhauge, the industries identified so far are merely the tip of the iceberg, and numerous other sectors are equally "plagued" by common ownership.[38]

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32 Jason Zweig, *Are Index Funds Eating the World?*, WALL ST. J., Aug. 26 , 2016.

33 *See* Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise and Failure of Financial Indices*, 30 YALE J. REG. 1 (2013); *Adriana Z. Robertson, Passive in Name Only: Delegated Management and "Index" Investing*, 36 YALE J. REG. 795 (2019) (for discussion of the nature of securities indices, which underpin index investing).

34 *See* BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 1 (for a description of modern index investing practice).

35 *Ibid*; Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 4, 2018), 3, 27 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812).

36 *See, e.g.*, José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) (airline industry); José Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252 (banking and finance); Yesha Yadav, "Common Agency in Bank Regulation", Working Paper (Fall 2017) (banking and finance).

37 José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).

38 Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1268 (2016); *See also* Einer Elhauge, *The Growing Problem of Horizontal Shareholding*, ANTITRUST CHRONICLE (Jun. 2017), 1-2.

Anti-common ownership scholars warn that the growth of shareholder diversification could have a variety of dire consequences,[39] potentially undermining the entire economy,[40] with harmful effects on consumer welfare and equality,[41] employment and wages,[42] and society as a whole.[43] The regulatory solutions suggested by some scholars to the supposed problems of the growth of institutional investors and common ownership are suitably Draconian.[44] They include depriving index funds of their voting rights;[45] restricting institutional investor share ownership to no more than one company in an oligarchy; and allowing institutional investors

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39 *See, e.g.*, Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029, 2133 (2019) (describing such warnings as "alarmism over common ownership").

40 *See* Einer Elhauge, *How Horizontal Shareholding Harms Our Economy – And Why Antitrust Law Can Fix It* (Aug. 2, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293822.

41 *See, e.g.*, Frank Partnoy, *Are Index Funds Evil?*, THE ATLANTIC, Sept. 2017 (https://www.theatlantic.com/magazine/archive/2017/09/are-index-funds-evil/534183/) (stating that "[u]ltimately, the new theory of common ownership is a theory about inequality: To the extent that passive investing shifts costs to consumers, it makes the rich richer, and the poor poorer"). *See also* Eric Posner & E. Glen Weyl, *Mutual Funds' Dark Side: Why Airlines and Other Industries Keep Prices Too High*, SLATE, Apr. 16, 2015; *See also* Einer Elhauge, *The Growing Problem of Horizontal Shareholding*, ANTITRUST CHRONICLE (Jun. 2017), 10.

42 Anti-common ownership literature also raises the issue of inequality, not only between shareholders and consumers, but also between shareholders and employees. *See, e.g.*, Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1292-93, 1300; Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 4, 2018), 15-16, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812; Einer Elhauge, *How Horizontal Shareholding Harms Our Economy – And Why Antitrust Law Can Fix It* (Aug. 2, 2019), 11 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293822 (claiming that common ownership advantages shareholders, who are "disproportionately wealthy" and "depresses employment and wages in a way that further disproportionately harms the non-wealthy").

43 *See, e.g.*, José Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019), 35 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252 ("[u]nfortunately, the benefits to shareholders from diversification and good governance may come at a cost to at a cost to consumers: efficient capital markets with perfect diversification and "good governance" imply deadweight losses in input and output markets") (an earlier version of this article argued that diversification and good governance harmed "society at large"). *See also* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018) (arguing that the likely result of index investing is serious economic harm); Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 4, 2018), 3, 26, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812 (arguing that "enormous harm" of this kind is already occurring as a result of common ownership).

44 *See generally* Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Involvement in Corporate Governance*, Law & Economics Research Paper Series Working Paper No. 17-05, Mar. 2017, 24-7 (outlining the various solutions to what they regard as a "non-problem").

45 Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018).

to hold shares in competing companies, only if those holdings do not exceed 1 percent, with forced divestiture in the case of non-compliance.[46]

III. THREE POSSIBLE NARRATIVES CONCERNING COMMON OWNERSHIP

At least three possible narratives might be derived from increased portfolio diversification by institutional investors, which is frequently in the form of common ownership across the same industry. Scholarship concerning the phenomenon of common ownership often shifts between these narratives, without necessarily specifying which version it is addressing.[47]

Version 1, which might be labelled "the lazy investor narrative", focuses on the general incentives and behavior of fund managers. The argument here is that portfolio diversification, particularly across companies in the same economic sector, may result in perverse or inadequate incentives for institutional investors to engage in strong monitoring.[48] This narrative suggests that, particularly from a cost-benefit analysis, it may not make sense for fund managers to adopt a private investor/owner-like stance toward individual companies in a widely diversified portfolio[49] and that rational apathy will therefore prevail.[50]

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46 *See generally* Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Involvement in Corporate Governance*, Law & Economics Research Paper Series Working Paper No. 17-05, Mar. 2017, 24-7, 25-6.

47 *See, e.g.*, Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018). At times Professor Lund argues that "passive" index investors lack the financial incentive to monitor their portfolio companies to ensure that they are managed effectively, which appears to be a variant of Version 1 below. *Id*, 495, 511, 512. She also argues, however, that these investors will "increasingly influence and even control the outcome of shareholder interventions", which suggests either Version 2 or Version 3 below. *Id*, 493.

48 *See, e.g.,* Edward Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018), 363, 373-74; Jill Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009 (1994). *See also* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029, 2075 (2019) (discussing a range of disincentives for index funds to invest adequately in stewardship or to challenge corporate management).

49 Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117, 146-48 (1988).

50 *See*, *e.g*., Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 473-74 (1991).

This narrative assumes that lack of interest by institutional investors in the performance of individual portfolio firms will be harmful to the company's performance. It suggests that lazy investors inevitably breed lazy managers,[51] whose desire to enjoy "the quiet life"[52] will override their responsibilities to the company and its shareholders. In this narrative, lack of attention by institutional investors enables the portfolio firm's managers to call the shots in favor of their own preferences and self-interest.

This was a familiar part of the so-called "passivity story" of the 1990s.[53] The underlying presumption in corporate governance literature during this period was that monitoring by institutional investors is a positive feature of corporate governance, and non-participation by such investors is a corporate governance problem in need of a solution.[54] Academic literature during the 1990s sought to find ways to overcome the legal and economic barriers to greater institutional investor engagement in corporate governance.[55]

Recent articles, by Professor Dorothy Lund and Professors Lucian Bebchuk and Scott Hirst, represent modern incarnations of this narrative.[56] Lund, for example, has argued within this paradigm that that index funds are quintessentially passive and ignorant investors, with

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51 *See*, *e.g*., José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1518, 1552 (2018) (suggesting that failure by institutional investors to demand or provide incentives for greater competition between portfolio firms may allow managers of those firms "to enjoy the 'quiet life'"). See also José Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019), 5 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252.

52 *See generally* Marianne Bertrand & Sendhill Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POLIT. ECON. 1043 (2003). *See also* Einer Elhauge, *The Growing Problem of Horizontal Shareholding*, ANTITRUST CHRONICLE (Jun. 2017), 5 (stating that "because competing vigorously is hard work for managers, they are less likely to do it unless their shareholders are actively pressing them to compete").

53 *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

54 *See, e.g*., G.P. Stapledon, *Disincentives to Activism by Institutional Investors in Listed Australian Companies*, 18 SYD. L. REV. 152, 154, 165 (1996); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811 (1992); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117 (1988).

55 Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. Rev. 811 (1992); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

56 *See* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029 (2019).

inadequate incentives to monitor management.[57] Bebchuk and Hirst are also concerned that index fund managers have incentives to under-invest in stewardship and to be overly deferential to the managers of portfolio companies.[58]

Yet, although the articles by these scholars reveal similar concerns, their regulatory prescriptions are quite different. Lund effectively adopts a punitive approach, arguing that index funds, as innately lazy investors, should therefore be deprived of their voting rights.[59] Bebchuk and Hirst, on the other hand, are more sanguine, suggesting reforms to counteract current incentives that nudge index fund managers toward passivity.[60] Their goal is to make index fund voting better informed and meaningful.[61]

Bebchuk and Hirst's approach is consistent with the policy goals in many parts of the world, where the aim is to increase, not decrease, corporate governance engagement by institutional investors, including index funds.[62] Lund's proposal, however, directly conflicts with those policy goals. Furthermore, discrimination of the kind advocated by Lund could be unlawful in jurisdictions where a one vote per share policy prevails.[63] It is interesting to note, for example, that, in Australia, an attempt to alter the corporate constitution of a company to disenfranchise institutional investors was struck down by the court on the basis that such inherent discrimination between different shareholder groups constituted fraud on the minority.[64]

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57 Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 512-13 (2018). *See also Capitalism's Unlikely Heroes: Why Activist Investors are Good for the Public Company*, THE ECONOMIST, Feb. 5, 2015. *Cf* Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 4, 2018), 3, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812.

58 Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029, 2035, 2050, 2059 (2019).

59 Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 528-30, 536 (2018).

60 Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029, 2118 (2019).

61 *Ibid*.

62 *See, e.g*., Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Active Investing*, 55 SAN DIEGO L. REV. 803 (2018); Jennifer G. Hill, *The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat*, [2019] U. ILL. L. REV. 507.

63 *See, e.g*., Douglas Appell, *One Share, One Vote' Remains Gold Standard Despite Challenges*, PENSIONS & INVESTMENTS, Aug. 7, 2017.

64 *See AFT v Clyde Industries Ltd* (1959) 59 SR (NSW) 33.

Versions 2 and 3 of the possible common ownership narratives differ significantly from Version 1. Whereas Version 1 raises concerns about lack of engagement by institutional investors, Version 2 suggests that they are too involved in corporate governance. Also, whereas Version 1 focuses on the danger of uncontrolled power by corporate managers, Versions 2 and 3 are underpinned by concern about the behavior and/or power of institutional investors themselves.

According to Version 2, which might be described as "the anticompetitive pressure model", where common ownership occurs across the same economic sector, institutional investors will have skewed incentives, leading them to abuse their ownership rights by pressuring managers of investee firms to act in an anticompetitive or collusive fashion. This narrative would seem to suggest that common ownership involves situations where institutional investors pressure managers of investee companies to engage in anticompetitive conduct.[65]

This interpretation of Version 2 appears to require active conduct by institutional investors to subvert competition between portfolio companies in the same sector. Such an interpretation accords with Professor Richard Buxbaum's suggestion almost twenty years ago that "a totally passive investor…may be easier to accept than an active one".[66]

At first sight, this interpretation of Version 2 would seem to exclude index funds, on the basis that they are passive investors only. Nonetheless, there is a broader interpretation of Version 2, which is capable of including index funds, by challenging the accuracy of their depiction as "passive investors".[67] It has been argued, for example, that, although index investors cannot vote

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65 *See* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1269 (arguing that "institutional investors usually…communicate with and actively seek to influence" their portfolio companies, although Elhauge, relying on Version 3 of the common ownership narrative, denies that this is a precondition to anticompetitive outcomes). Note also that some anti-common ownership theorists rely on negative, rather than positive, pressure by institutional investors—interpreting *failure to pressure* management to compete aggressively as having an equivalent anticompetitive effect. *See* Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 4, 2018), 28-9, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812 (stating that "reduction in pressure itself will likely have anticompetitive effects"); José Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019), 5-6 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252.

66 Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOKLYN L. REV. 1, 21 (1990).

67 *See, e.g.*, Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 (2016).

on, or influence, the competitive strategies of their portfolio firms,[68] they, nonetheless, behave as active investors when they exercise rights attached to their shares with respect to governance matters (such as nomination of board members, executive compensation) and engage in dialogue with management.[69]

Indeed, large asset managers themselves reject the notion that they are "passive". Vanguard has stated, for example, "[w]e believe that our active engagement demonstrates that passive investors don't need to be passive owners."[70] Similarly, BlackRock has criticized the supposed dichotomy between active and passive shareholders as superficial, suggesting that most traditional asset managers adopt an approach midway between these two outer points.[71] Also, the majority of index funds are not stand-alone funds. Rather, they are part of investment fund families, which will include active funds, and this may provide index funds with incentives to improve the corporate governance of a given company, in circumstances where that would improve performance of the fund family as a whole.[72] Moreover, even when index funds track a particular index, fund managers will have some discretion in terms of the relative weighting they give to stock in that index.[73]

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68 *See, e.g.*, José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1557 (2018). (stating "[w]e do not mean to suggest here that shareholders vote directly on competitive strategies"). *See also* BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 8. *See also* Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Involvement in Corporate Governance*, Law & Economics Research Paper Series Working Paper No. 17-05, Mar. 2017, 9.

69 *See, e.g.*, José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1553*ff* (2018).

70 Vanguard website (cited in Eric Posner et al., *A Monopoly Trump Can Pop*, N.Y. Times, Dec. 7, 2016, A29). *See also* Charles Stein, *McNabb Says Firm is Not Passive on Governance*, BLOOMBERG BUSINESS, Mar. 4 , 2015. *Cf*, however, Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 497 (2018) (who makes a sharp distinction between institutional investors that adopt an active corporate governance engagement strategy and "passive" index funds).

71 *See* BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 1, 8. *See also* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 Colum. L. Rev. 2029 (2019); Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuk–Strine Debate*, 12 N.Y.U. J. L & BUS. 385 (2016); Jill Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, *University of Pennsylvania Law Review Institute for Law and Economics Research Paper No. 18-12*, May 19, 2019 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3192069) (forthcoming 2019, U. PENN L. REV.).

72 *See generally* Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, *NYU Law and Economics Research Paper No. 18-39*, Apr. 4, 2019 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098).

73 *See, e.g.*, Vanguard, *What Affects Index Tracking* (available at https://advisors.vanguard.com/VGApp/iip/site/advisor/etfcenter/article/ETF_IndexTracking).

Institutional investors have also stressed that, since they are effectively locked into their investment for the long term, they need to engage with the managers of the companies in which they invest.[74] Under Version 1 of the common ownership narrative, increased engagement in corporate governance by large institutional investors reflects good corporate governance. Under the more expansive interpretation of Version 2, it is dangerous, in that it potentially involves transmission of anticompetitive incentives to portfolio firms.[75]

Version 3 of the common ownership narrative does a significant pivot in terms of perspective. Unlike Version 2, which examines the incentives and behavior of institutional investors, Version 3 instead focuses solely on the incentives and behavior of corporate managers of the investee firms, albeit under the shadow of institutional investor power. In so doing, Version 3 eliminates the need to show any misuse of share ownership rights by institutional investors; it is immaterial whether investors are active or passive. Under Version 3, which might be called "the mindreading model", it is sufficient that the corporate managers of the portfolio firm are aware that common ownership exists in their sector, on the basis that this awareness allows them to discern, and follow, the presumed anticompetitive preferences of large diversified investors. Adopting the mindreading model, some anti-common ownership scholars have predicted that managers who correctly divine institutional investor preferences by "either conscious calculation, intuition, or pure luck"[76] will tend to be selected to run the firm.[77] In evolutionary terms, this would appear to be a variant of natural selection.[78]

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74 *See* Vanessa Desloires, *Blackrock, Vanguard, State Street are Not Passive on Corporate Governance*, SYDNEY MORNING HERALD, Nov. 1, 2016.

75 *See* José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1558 (2018); José Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019), 5 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252.

76 José Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019), 5 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252.

77 *Ibid*.

78 *See*, *e.g*., Emily Osterloff, *What is Natural Selection?*, NATURAL HISTORY MUSEUM, Mar. 18, 2019 (describing "natural selection" as an evolutionary mechanism by which "[o]rganisms that are more adapted to their environment are more likely to survive…")

Version 3 of the common ownership narrative goes substantially further than Version 2. Under Version 3, the allegedly anticompetitive incentives are "purely structural",[79] deriving from the mere fact of common ownership. Indeed, under this version of the common ownership narrative, it is irrelevant that:-

- all the financial interests are merely minority shareholdings;[80]
- the institutional investors have not themselves engaged in any conduct to achieve anticompetitive ends;[81]
- there has been no attempt by institutional investors to communicate with, or influence, managers of the portfolio company;[82] and
- there is no coordination or collusion between managers of competing companies.[83]

According to Elhauge, who adopts Version 3 of the common ownership narrative, where institutional investors own shares in competing companies, those investors are liable under US antitrust law if their pattern of ownership lessens competition, regardless of whether they have undertaken any positive actions to contribute to such an outcome.[84] This is a startling

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79 Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1270 (2016). *See also* Einer Elhauge, *The Growing Problem of Horizontal Shareholding*, ANTITRUST CHRONICLE (Jun. 2017), 2.

80 José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).

81 Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1270 (2016).

82 *See* Einer Elhauge, "How Horizontal Shareholding Harms Our Economy – And Why Antitrust Law Can Fix It" (Jul. 25, 2019), 5 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293822 (arguing that shareholder communications become irrelevant in lessening competition when incentives in executive compensation achieve that aim); Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 4, 2018), 2, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812. *See also* Einer Elhauge, *The Growing Problem of Horizontal Shareholding*, ANTITRUST CHRONICLE (Jun. 2017), 2; Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1269 (2016). Elhauge notes, however, that communication by institutional investors to managers, in fact, often occurs. *Id*, 1269-70.

83 See José Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019), 4-5 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252; Einer Elhauge, *How Horizontal Shareholding Harms Our Economy – And Why Antitrust Law Can Fix It* (Jul. 25, 2019), 1-2 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293822; Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1270; *See also* Einer Elhauge, *The Growing Problem of Horizontal Shareholding*, ANTITRUST CHRONICLE (Jun. 2017), 2; Einer Elhauge, *New Evidence, Proofs, and Legal Theories on Horizontal Shareholding* (Jan. 4, 2018), 2, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096812; Eric Posner & E. Glen Weyl, *Mutual Funds' Dark Side: Why Airlines and Other Industries Keep Prices Too High*, SLATE, Apr. 16, 2015.

84 *See generally* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016).

proposition. It is reminiscent of Justice Louis Brandeis's comment more than a hundred years ago that "[t]here is no such thing…as an innocent stockholder".[85]

IV. THE THEORY OF COMMON OWNERSHIP FROM A CORPORATE GOVERNANCE PERSPECTIVE

The common ownership theory subverts many fundamental tenets of contemporary corporate governance concerning the desirability of increased shareholder engagement. Version 3 of the common ownership narrative posits that mere ownership of shares by institutional investors across concentrated industries can *ipso facto* breach competition laws. This is a sufficiently disquieting proposition as to warrant close scrutiny of the common ownership theory from a corporate governance perspective. There are a number of points that can be made about the common ownership theory, which suggest possible weaknesses in its conclusions.

IV.1 Common Ownership is a Controversial and Broadbrush Theory

In spite of its early academic impact, it is worth remembering that the common ownership theory is just that—a theory—and that theorizing about the possible anticompetitive effects of common ownership on managerial incentives does not prove that those effects occur in practice.[86] Not does it prove that any anticompetitive behavior which does exist is caused by common ownership.[87] A recent empirical study by Professor Erik Gilje et al.[88] for example, provides data to assess the extent to which the theory represents reality, and its findings suggest that in many instances, the empirical evidence does not conform to theory in relation to common ownership.[89]

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85 *Big Corporations Dangerous to Workers Says Brandeis*, READING EAGLE, Jan. 23, 1915, 6.

86 *See* BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 2, 6-7, 15.

87 *Ibid*.

88 *See* Erik P. Gilje et al., *Who's Paying Attention? Measuring Common Ownership and Its Impact on Managerial Incentives*, (NBER Working Paper No. 25644, Mar. 2019).

89 *Ibid*.

Not only is the common ownership argument just a theory, it is also a very broad-brush theory, which contains several puzzling elements. For example, one curious aspect of the mindreading model, Version 3 of the common ownership narrative, is why corporate managers would, without any pressure or direction, act in the presumed interests of institutional investors with diversified portfolios. Elhauge suggests that corporate managers might behave in this way for a litany of possible reasons—"out of a sense of fiduciary duty or gratitude, to gain support in future elections, to enhance future job prospects, because executive compensation methods align with shareholder interests, or so their shareholders will fend off takeover threats".[90] Also, discerning institutional investors' presumed preferences under Version 3 will be no easy task. Those interests and preferences are heterogeneous and constantly in flux, rendering the assessment that corporate managers are required to make difficult and prone to miscalculation.[91]

Such far-reaching suppositions about the means by which anticompetitive incentives might be transmitted from institutional investors to corporate managers suggest the need for further empirical research, like the Gilje et al. study,[92] to bring greater clarity to the investigation of whether corporate managers actually behave in this way and, if they do, why this occurs and under what circumstances. A growing number of studies have challenged the empirical underpinnings of the common ownership theory,[93] and the mechanisms, including executive

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90 Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1270 (2016).

91 *See* Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Involvement in Corporate Governance*, Law & Economics Research Paper Series Working Paper No. 17-05, Mar. 2017, 5.

92 Erik P. Gilje et al., *Who's Paying Attention? Measuring Common Ownership and Its Impact on Managerial Incentives*, (NBER Working Paper No. 25644, Mar. 2019).

93 *See, e.g.*, Patrick Dennis et al., *Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry* (Working Paper, Aug. 12, 2019) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3063465; Pauline Kennedy et al., *The Competitive Effects of Common Ownership: Economic Foundations and Empirical Evidence* (Working Paper, Jul. 26, 2017 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3008331).

remuneration,[94] which have been suggested might provide the necessary conduit for transmission of anticompetitive incentives to corporate management.[95]

IV.2 The Common Ownership Theory Includes Some Questionable Underlying Presumptions

The common ownership argument also includes several questionable presumptions in reaching its conclusion that corporate managers will behave in an anticompetitive way. As already noted, Version 2 of the common ownership narrative surmises that institutional investors will exert anticompetitive pressure on corporate managers of investee firms. Version 3 goes further, by suggesting that institutional investors, including index funds, are so powerful that the corporate managers will do their presumed bidding, even in the absence of such pressure. Shareholder power and participation in corporate governance in the United States has undoubtedly increased in recent years,[96] but are institutional investors as formidable as anti-common ownership scholars suggest?

Versions 2 and 3 of the common ownership narrative contradict the traditional image of the institutional investor as passive[97] and a "paper colossus",[98] since they presume high levels of institutional investor influence. In fact, US shareholders have far fewer statutorily guaranteed corporate governance participatory rights than shareholders in other common law jurisdictions, including the United Kingdom and Australia.[99] Also, recent studies highlight the fact that

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94 *See* David I. Walker, *Common Ownership and Executive Incentives: The Implausibility of Compensation as an Anticompetitive Mechanism* (Boston University School of Law, Law & Economics Series Paper No. 19-3, Mar. 2019) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3345120).

95 *See, e.g.*, C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership* (Working Paper No. 423/2018, Mar. 2019) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3210373) (forthcoming, YALE L.J.).

96 *See generally* Jennifer G. Hill, *The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat*, [2019] U. ILL. L. REV. 507.

97 *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

98 *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director*, 43 STAN. L. REV. 863, 863 (1991).

99 *See* Jennifer G. Hill, *The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat*, [2019] U. ILL. L. REV. 507; Jennifer G. Hill, *Subverting Shareholder Rights: Lessons from News Corp.'s Migration to Delaware*, 63 VAND. L. REV. 1 (2010).

institutional investors direct relatively limited resources toward corporate monitoring.[100] These studies show that investment managers of mutual funds, both indexed and actively managed, have incentives to spend negligible amounts on stewardship,[101] and to side excessively with managers of corporations.[102] These studies suggests that, rather than corporate managers bending to institutional investors' pressure (Version 2) or presumed preferences (Version 3), institutional investors, in fact, generally follow the lead of the corporate managers.[103] Also, even when investors do flex their muscles by, for example, seeking stronger governance rights, management often responds by engaging in "private ordering combat",[104] to try to modify or dilute the rights sought by shareholders.[105]

IV.3 Recognition of the Link Between Concentrated Ownership and Antitrust Law is Not New

The references to common ownership by institutional investors as a "blockbuster" discovery,[106] and its description as the "great, but mostly unknown, antitrust story of our time"[107] suggest

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100 *See, e.g.* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029, 2050 (2019); Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPECTIVES 89 (2017). *See* also Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Active Investing*, 55 SAN DIEGO L. REV. 803 (2018).

101 *See* Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPECTIVES 89, 100 (2017).

102 *See* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and* Policy, 119 COLUM. L. REV. 2029 (2019); Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPECTIVES 89 (2017). *See* also Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 523-26 (2018).

103 This conclusion accords with the findings of the Gilje, Gormley and Levit study on the impact of index investing on managerial incentives. Erik P. Gilje et al., *Who's Paying Attention? Measuring Common Ownership and Its Impact on Managerial Incentives*, (NBER Working Paper No. 25644, Mar. 2019). *See also* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029 (2019); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 512-13 (2018).

104 *See* Jennifer G. Hill, *The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat*, [2019] U. ILL. L. REV. 507, 524-40.

105 *Ibid*.

106 *See* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1283 (2016) (attributing the lack of antitrust enforcement to date to the fact that the link between horizontal shareholding and anticompetition issues has only recently been recognized).

107 Eric Posner et al., *A Monopoly Trump Can Pop*, N.Y. TIMES, Dec. 7, 2016, A29.

that the link between the growing concentration of share ownership and antitrust issues has only recently been uncovered. This is not, in fact, the case. Corporate governance literature from the early 1990s onwards focused on the governance implications of concentration of share ownership associated with the rise of institutional investment.[108] Buxbaum, for example, highlighted the fact that a broadening of portfolio distribution was the inevitable consequence of the absolute growth of institutional investment pools,[109] while Professor Bernard Black sought ways of ensuring increased "institutional voice",[110] in accordance with Version 1 of the common ownership narrative discussed above.

These scholars also explicitly considered the growth in concentrated ownership and portfolio diversification from a competition law perspective. Yet, they concluded that antitrust law constituted a very weak constraint on institutional investors.[111] Although Buxbaum acknowledged the theoretical possibility that institutional investors could contravene antitrust laws, the potential scenarios in which he thought this might occur went well beyond mere common ownership, as envisaged under Version 3. Rather, Buxbaum's examples involved coordinated forms of institutional investor activism,[112] such as a targeted collective boycott against a particular firm.[113] Black also considered this issue,[114] and, like Buxbaum, viewed the risk at that time to be "entirely theoretical", and subject to countervailing factors that reduced the likelihood of antitrust violations.[115] The approach of Buxbaum and Black is consistent with

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108 *See also* Frank Partnoy, *Are Index Funds Evil?*, THE ATLANTIC, Sept. 2017 (https://www.theatlantic.com/magazine/archive/2017/09/are-index-funds-evil/534183/) (tracing the origins of the common ownership argument back to a 1984 paper by Julio Rotemberg).

109 Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOKLYN L. REV. 1, 3 (1991).

110 *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 815-16 (1992).

111 Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOKLYN L. REV. 1, 25 (1991).

112 *Id*, 25, n. 94.

113 *Id*, 25.

114 Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 870-71 (1992).

115 *Ibid*. *See* also Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 558-59 (1990).

a narrow reading of Version 2 of the common ownership narrative, which would require actual misuse of ownership rights by institutional investors to achieve anticompetitive ends.[116]

Professors Rock and Rubinfeld have addressed this issue more recently and come to a similar conclusion.[117] Although acknowledging that common ownership by institutional investors could in certain circumstances have anticompetitive effects, Rock and Rubinfeld find no persuasive evidence that this state of affairs currently exists.[118] BlackRock has similarly criticized the common ownership theory as based on "fragile evidence" in this regard.[119]

IV.4 Common Ownership is a US-Centric and Industry-Specific Debate

Although the common ownership debate is now spreading around the world, its origins are inherently US-centric in their focus on particular American industries. Nonetheless, the market for capital is now global and there are developments, both in the United States and elsewhere in the world, which potentially affect that investment ecosystem and the common ownership debate. For example, in recent years there has been a striking reduction in the number of public companies in the United States,[120] which has increased the importance of global investment opportunities for US institutional investors.

American companies are not always competing with each other. Indeed, they are not always competing with companies that have the same governance structures, as is shown by the rise

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116 In Australian competition law context, it is interesting to note that amendments were introduced in November 2017, which prohibit "a concerted practice that has the purpose, or has or is likely to have the effect, of substantially lessening competition". See Competition and Consumer Act 2010 (Cth.), s 45. *See generally* Rob Nichols & Deniz Kayis, *Common Corporate Owners, Concerted Corporate Actions?* (2019, Working Paper, on file with the author).

117 Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Involvement in Corporate Governance*, Law & Economics Research Paper Series Working Paper No. 17-05, Mar. 2017.

118 *Ibid*. Rock and Rubinfeld dismiss the common ownership argument, by stating, "[w]e have considered the antitrust attack on widely diversified institutional investor ownership, and found it lacking". *Id*, 37.

119 BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 2, 6-7. *See* also C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, NYU Law & Economics Research Paper No. 18-29, Mar. 2019 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3210373), 42 (arguing that there is there is "no strong theoretical basis" for the assumptions that underlie the common ownership theory).

120 *See generally* Ira M. Millstein Center for Global Markets and Corporate Ownership, *Private Ownership at a Public Crossroads: Studying the Rapidly Evolving World of Corporate Ownership*, Feb. 2019.

of Chinese State-Owned Enterprises (SOEs).[121] Whereas some of the industry clusters considered in the common ownership literature, such as the banking and the airline industries, may be US oligopolies, others, such as technology and pharmaceutical sectors, are now global markets. Even in concentrated industries, spillover effects in other industries and other markets, in which highly diversified shareholders are invested, will necessarily complicate any assessment of investor incentives.[122]

From a global investment perspective, it is interesting to examine The Norwegian Government Pension Fund Global ("the Norwegian oil fund"),[123] which is the world's largest sovereign wealth fund, with over US$1 trillion in assets.[124] In 2015, the fund announced that it was moving from passive investment to adopting an active owner stance.[125] It now has stakes in over nine thousand companies in seventy three countries, and owns an average of 1.4 percent of every company listed on any stock market around the world.[126] The Norwegian oil fund's record breaking 2017 annual return of US$ 131 billion[127] was largely attributable to its broad

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121 *See* Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697 (2013). High levels of state control are also found in a number of other jurisdictions, such as Singapore. *See*, *e.g.*, Luh Luh Lan and Umakanth Varottil, *Shareholder Empowerment in Controlled Companies: The Case of Singapore*, *in* RESEARCH HANDBOOK OF SHAREHOLDER POWER 572 (Jennifer G. Hill & Randall S. Thomas eds., 2015).

122 *See, e.g.*, Madison Condon, *Externalities and the Common Owner* (forthcoming 2019, WASH. L. REV.); Alessandro Romano, *Horizontal Shareholding: The End of Markets and the Rise of Networks* (Working Paper, Sept. 2018).

123 The Norwegian oil fund is managed by Norges Bank Investment Management, which is the asset management arm of Norway's central bank, Norges Bank. *See* Norges Bank Investment Management, *About Us*, https://www.nbim.no/en/organisation/about-us/.

124 *See* Norges Bank Investment Management, *A Trillion Dollar Fund*, Sept, 19, 2017, https://www.nbim.no/en/transparency/news-list/2017/a-trillion-dollar-fund/.

125 Richard Milne, *Norway Oil Chief Jettisons Passivity*, FIN. TIMES, Aug. 10, 2015.

126 *See* Norge Bank Investment Management website, https://www.nbim.no/; Norges Bank Investment Management, Government Pension Fund Global Annual Report 2018, 1, https://www.nbim.no/contentassets/02bfbbef416f4014b043e74b8405fa97/annual-report-2018-government-pension-fund-global.pdf.

127 Note, however, that in 2018 the Norwegian oil fund returned -6.1 percent, its worst result since 2008, during the global financial crisis, as a result of financial volatility. *See* Norges Bank Investment Management, Government Pension Fund Global Annual Report 2018, 1, https://www.nbim.no/contentassets/02bfbbef416f4014b043e74b8405fa97/annual-report-2018-government-pension-fund-global.pdf; *Norway's Oil Fund Reports Worst Annual Results Since 2008*, CENTRAL BANKING, Feb. 27, 2019.

investment strategy, coupled with the strong performance of technology stocks in its global portfolio, including Apple and Microsoft in the United States and Tencent in China.[128]

As noted, the largest US institutional investors are also increasingly involved in international markets. Although they tend to have investments in far fewer companies than the Norwegian oil fund, their investment levels are, on average, higher. For example, it is estimated that BlackRock owns at least 5 percent of over 2,600 companies worldwide and Vanguard owns around the same level of 1,800 companies worldwide.[129]

The investment strategy of the Norwegian oil fund is based on the objective of "maximising return with moderate risk".[130] The kind of restrictions that are suggested by anti-common ownership scholars would seriously undermine the investment strategies of US institutional investors which, like the Norwegian oil fund, seek to use broad portfolio diversification as a risk management tool.

IV.5 Common Ownership in Megacompanies

Another problematic aspect of the common ownership hypothesis is its focus on institutional investors, rather than on the rise in market power of the investee firms themselves. If these firms have indeed engaged in anticompetitive behavior, it might be thought that they would be more obvious targets for competition law than their shareholders.[131] Yet, by targeting investment patterns, the common ownership literature obscures the fact that the firms in some

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128 *See* Richard Milne, *Norway Oil Fund Posts $131 Billion Return for 2017*, FIN. TIMES, Feb. 27, 2018; Eshe Nelson, *How Norway's Sovereign Wealth Fund Made $130 Billion Dollars in One Year*, WORLD ECONOMIC FORUM, Mar. 5, 2018; Mark Sweeney, *The $500bn Tech Firm You May Have Never Heard of*, THE GUARDIAN, Jan. 13, 2018. The Norwegian Oil Fund's returns on its equity holdings were significantly reduced in 2018, due to global political and trade instability. *See* Katie Martin, *Norway Oil Fund Returns Narrowly Miss Benchmark in Second Quarter*, FIN. TIMES, Aug. 21, 2018.

129 *See* Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. AND POLITICS 298, 312, Table 2 (2017).

130 *See* Norges Bank Investment Management, *Investment Strategy for the Government Pension Fund Global*, Letter to the Ministry of Finance, Nov. 16, 2017, https://www.nbim.no/en/transparency/submissions-to-ministry/2017/investment-strategy-for-the-government-pension-fund-global/.

131 Frank Partnoy, *Are Index Funds Evil?*, THE ATLANTIC, Sept. 2017 (https://www.theatlantic.com/magazine/archive/2017/09/are-index-funds-evil/534183/).

sectors, such as the technology sector, have themselves become "powerful megacompanies".[132] This is reflected in Apple's 2018 market valuation of $1 trillion,[133] and in Senator Elizabeth Warren's proposal to break up companies, such as Amazon, Facebook and Google.[134]

Several recent studies have shown a dramatic increase in the size and concentration levels of companies in some industries, including in the banking sector and airlines sector, which feature so prominently in the common ownership debate.[135] For some economists, it is the corporate consolidation and concentration of power in a small number of megacompanies, rather than their capital structure, which has created problems relating to wage inequality[136] and consumer welfare.[137] This suggests the possibility that the common ownership theory may reflect correlation, rather than causation.[138]

The regulatory implications of this approach are that the law should target the companies that engage in anticompetitive conduct, rather than targeting institutional investors, by restricting their ability to own shares in competing companies.[139] A recent report of the Australian

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132 Matt Phillips, *Apple's $1 Trillion Milestone Reflects Rise of Powerful Megacompanies*, N.Y. TIMES, Aug. 2, 2018.

133 *Ibid*.

134 *See* David Smith, *Elizabeth Warren Vows to Break Up Amazon, Facebook and Google If Elected President*, THE GUARDIAN, Mar. 9, 2019.

135 *See, e.g.,* Gustavo Grullon et al., *Are US Industries Becoming More Concentrated?*, 23 REV. FIN. 697 (2019). *See also* Kathleen Kahle & René M. Stulz, *The Shrinking Number of Public Corporations in the US*, LSE BUS. REV., Oct. 17, 2017 (noting the massive increase in market concentration in the United States between 1975 and 2015, in which "the winners have done well"); Ira M. Millstein Center for Global Markets and Corporate Ownership, *Private Ownership at a Public Crossroads: Studying the Rapidly Evolving World of Corporate Ownership*, Feb. 2019.

136 *See* Rachel Abrams, *7 Fast-Food Chains to End "No Poach Deals that Lock Down Low Wage Workers*, N.Y. TIMES, Jul. 12, 2018. *See* also Alan B. Krueger & Orley Ashenfelter, *Theory and Evidence on Employer Collusion in the Franchise Sector*, Working Paper, Jul. 18, 2017 (http://conference.nber.org/confer//2017/SI2017/LS/Krueger_Ashenfelter.pdf) (examining use of market power and collusive actions by employers to suppress wages and restrict competition).

137 *See*, *e.g*., Gustavo Grullon et al., *Are US Industries Becoming More Concentrated?*, 23 REV. FIN. 697 (2019).

138 *See also* BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 2 (arguing that the common ownership research in the economics literature does not provide a "plausible causal explanation of how common ownership can lead to higher prices"). *See* also *id*, 6-7, 15.

139 *See*, *e.g*., Alan B. Krueger & Orley Ashenfelter, *Theory and Evidence on Employer Collusion in the Franchise Sector*, Working Paper, Jul. 18, 2017, (http://conference.nber.org/confer//2017/SI2017/LS/Krueger_Ashenfelter.pdf), 2-3.

Government Productivity Commission adopts this approach in relation to Australia's extremely concentrated financial sector.[140] Acknowledging that these huge financial institutions "have the ability to exercise market power over their competitors and consumers",[141] the report adopts a targeted approach to anticompetitive conduct by such firms that may exploit their customers.[142]

In an era of megacompanies, the presence of large powerful institutional investors as a counterweight is not necessarily an undesirable corporate governance development.

IV.6 Investee Firm Managers and Their Fiduciary Duties

The common ownership theory not only diverts attention from potentially anticompetitive conduct of portfolio companies themselves, but it also diverts attention from the conduct of directors and officers of those firms.[143] As Commissioner Hayne stressed in Australia's recent high profile Banking Royal Commission,[144] directors and officers are required to exercise their duties for the benefit of their corporation, which involves more than considering merely financial returns to shareholders.[145] Furthermore, Commissioner Hayne disputed the idea that the interests of shareholders and customers are opposed,[146] noting that the interests of both

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140 *See* Australian Government Productivity Commission, *Competition in the Australian Financial System: Productivity Commission Inquiry Report: Overview & Recommendations*, No. 89, 29 Jun. 2018.

141 *Id*, 2.

142 *See* James Frost, *Productivity Commission's Final Report Lashes Banks for Exploiting Customers*, AUST. FIN. REV., 3 August 2018; AGPC, *Competition in the Australian Financial System: Productivity Commission Inquiry Report: Overview & Recommendations*, No. 89, Jun. 29, 2018, 2, 16-17, 24-25, 45, 53. As the report notes, an extremely profitable financial system is "not necessarily a bad thing", provided it is "workably competitive". *Id*, 12.

143 *See* Daniel P. O'Brien & Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less Than We Think*, 81 ANTITRUST L.J. 729, 765-66. *See* AGPC, *Competition in the Australian Financial System: Productivity Commission Inquiry Report: Overview & Recommendations*, No. 89, Jun. 29, 2018, 2, 24-25, 45.

144 Commonwealth of Australia, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry,* Final Report (2019).

145 *Id,* 402.

146 *Id*, 403.

groups will generally converge when directors and officers act in the long-term financial best interests of the corporation.[147]

The Banking Royal Commission's Final Report took the view that, in addition to the banks themselves, their boards and senior managers bore responsibility for misconduct, which enhanced corporate profits by exploiting customers.[148] This raises the possibility that corporate managers could themselves be liable for breach of either the duty of care or the duty to act in good faith in the best interests of the company as a whole. Although liability for breach of the duty of care is unlikely under US corporate law,[149] due to the capacious protection offered by the business judgment rule and exculpatory clauses, directors and officers face a much greater risk of liability under Australian law.[150] It is, therefore, arguable that if, under Version 2 or Version 3 of the common ownership narrative, directors and managers of investee firms engaged in anticompetitive conduct (based on the actual or presumed preferences of a segment of the body of shareholders), those directors and officers would breach their statutory duties to the company under Australian law.[151]

IV.7 Institutional Investors and the Growing Importance of ESG

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147 *Ibid*.

148 Commonwealth of Australia, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, Final Report, Feb. 1, 2019 4 (available at https://financialservices.royalcommission.gov.au/Pages/reports.aspx#final).

149 But note *Marchand v Barnhill*, No. 533, 2018 (Del., Jun. 19, 2019), in which the plaintiffs successfully pleaded that the directors were not protected under the *Caremark* doctrine (*In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch., 1996)).

150 This is due to the availability of "stepping stone" liability under Australian law, whereby directors and officers may be personally liable for failure to prevent contraventions of the law by their corporation. *See, e.g.,* Abe Herzberg & Helen Anderson, *Stepping Stones - From Corporate Fault to Directors' Personal Civil Liability*, 40 FED. L. REV. 181 (2012); Tim Bednall & Pamela Hanrahan, *Officers' Liability for Mandatory Disclosure: Two Paths, Two Destinations?*, 31 COMP. & SEC. L.J. 474 (2013); Alice Zhou, *A Step Too Far? Rethinking the Stepping Stone Approach to Officers' Liability*, 47 FED. L. REV. 151 (2019).

151 These statutory duties are primarily enforceable by the Australian securities regulator, ASIC. For a comparison of enforcement of directors' duties under US and Australian law, see Reneé Jones and Michelle Welsh, *Toward a Public Enforcement Model for Directors' Duty of Oversight*, 45 VAND. J. TRANSNAT'L L. 343 (2012).

The common ownership theory is focused almost exclusively on the goal of profit maximization.[152] It arguably ignores one of the most important developments in current international corporate governance, namely the growing importance of environmental, social and governance (ESG).[153] Large institutional investors increasingly view a diverse range of ESG factors, such as climate change,[154] sustainability[155] and gender diversity on boards,[156] as inherent aspects of risk management, and these issues now account for the majority of all shareholder proposals filed in the United States.[157] Also, a growing number of international Shareholder Stewardship Codes explicitly refer to investor stewardship responsibilities regarding ESG.[158] For example, the 2020 UK Shareholder Stewardship Code for the first time explicitly recognizes the growing importance of ESG matters to institutional investors.[159]

One recent paper effectively flips the central argument of anti-common ownership scholars on its head, by arguing that portfolio-regarding intervention by the largest institutional investors may have beneficial outcomes from a social welfare perspective.[160] The paper argues that large diversified investors are, indeed, sometimes prepared to exert their growing power over individual firms for the benefit of their portfolio companies, but that, rather than seeking to reduce competition, they do this to control the effects of firm-level negative externalities of

152 *See generally* Jennifer G. Hill, "Corporations, Directors' Duties and the Public/Private Divide", *in* FIRM GOVERNANCE: THE ANATOMY OF FIDUCIARY OBLIGATIONS IN BUSINESS (Arthur Laby and Jacob Russell eds., forthcoming 2020) (arguing that corporate financial performance is only one of multiple problems in corporate law and that an equally important problem is the danger that corporate conduct result in negative externalities and harm to society).

153 *See*, *e.g*., BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 8-9.

154 *See, e.g*., BlackRock, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance* (2020); Heather Landy, *A $ 7 Trillion Wall Street Powerhouse is Finally Matching its Climate-Change Rhetoric with Action*, QUARTZ, Jan. 15, 2020.

155 *Ibid*.

156 *See*, *e.g*., Janet Albrechtsen and Andrew White, *Corrigan Attacks Gender Targets*, THE AUSTRALIAN, May 19, 2018.

157 *See* ALLIANCE ADVISERS, 2019 PROXY SEASON PREVIEW, 1, 4*ff* (2019), https://allianceadvisors.com/wp-content/uploads/2019/04/Alliance-Advisors-Newsletter-Apr.-2019-2019-Proxy-Season-Preview.pdf.

158 *See* Jennifer G. Hill, *Good Activist/Bad Activist: The Role of International Stewardship Codes*, 41 SEATTLE U. L. REV. 497.

159 *See* Financial Reporting Council, *The UK Stewardship Code* 2020, Principle 7 (2020).

160 *See* Madison Condon, *Externalities and the Common Owner* (forthcoming 2019, WASH. L. REV.).

climate change on their entire portfolio.[161] This development contradicts not only the profit-focused Versions 2 and 3 of common ownership, but also Version 1, the lazy investor narrative.[162]

V. CONCLUSION

Anti-common ownership scholars propose an intriguing theory, but further empirical studies are required to determine whether it accords with reality. The regulatory prescriptions offered by the more extreme versions of the common ownership narrative would have dire regulatory consequences and result in wholesale discrimination against certain shareholders. They would effectively unravel the benefits of investment diversification and democratization of wealth.[163] If further studies determine that there are indeed "hidden costs"[164] to common ownership, the role of the law should be to craft an effective, but appropriately targeted, response to that problem.

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161 *Ibid*.

162 *Ibid*.

163 *See* BlackRock, *Index Investing and Common Ownership Theories*, VIEWPOINT, Mar. 2017, 1.

164 Frank Partnoy, *Are Index Funds Evil?*, THE ATLANTIC, Sept. 2017 (https://www.theatlantic.com/magazine/archive/2017/09/are-index-funds-evil/534183/).

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