The Common Ownerships Conundrum

By Guest / October 29, 2018 / 9 Min read / Add comment

*[**Parag Srivastava** and **Poonam Pal Sharma** are members of the law firm Nishith Desai Associates. The views represented in this post are strictly personal and do not represent the views of the firm]*

The insidious yet hitherto unspoken subject of horizontal shareholders has been in recent limelight due to its mention in the order by the Competition Commission of India ("**CCI**") in its Ola Meru Cabs Case.[1] Though the CCI did not find sufficient evidence in the Ola Meru Cabs Case to suggest that any harm was caused as a result of horizontal shareholdings in Ola and Uber, it did not rule out the possibility of implementing safeguards in case of affirmative evidence.

Horizontal shareholdings, in essence, is common shareholding by investors across competing entities. At the time being, given the abundant uncertainty on this subject matter (from an empirical evidence perspective) and considering the intersection of investment interests by the investors these days, the potential impact of horizontal shareholdings becomes important to understand. We can perhaps start by breaking this down into four main questions that logically arise on the subject matter:

1. *Whether common investors in competing firms can influence the management of competing entities for their benefit and if so by what means?*
2. *Can the manner in which a company (in this case, a competing entity) operates be altered by the influence by common investors?*
3. *At what level can such common ownerships pose a competitive risk?*
4. *Lastly, are there any precautionary measures that can be adopted by (common) institutional investors in such a situation?*

We address the first two questions together.

Influencing the management of an entity or exercising 'control' over such entity can occur either by means of *de facto* control, *de jure* control (controlling interest) or by

exercise of material influence[2] over such entity. Such influence, when used for the benefit of common investors instead of investee companies can have the effect of softening competition between players in the same industry. By means of such authority over the entity, common investors can maximize their profits either in the manner of controlling the conduct of businesses for e.g. simply by determining product prices to encourage shift of consumers from one preferred player to another in the same industry or by providing incentives to managers to encourage collusive behaviour between such competing entities.[3]

Today, an investor need not be a majority shareholder or an active investor in a company to be in control of such an entity. Material influence over the operational decisions of a company through exercise of a veto on operational matters can also lead to controlling the conduct of an entity and this, if used inappropriately, may become detrimental when the same set of investors 'control' competing entities through such influence. Economists have also provided a general warning for portfolio managers in their recent studies not to facilitate cartel like behaviour through horizontal shareholdings.[4]

A few economists have however argued, based on empirical evidence, that prices in the airlines industry and rate of interests in the banking industry in the US have been managed by horizontal shareholdings.[5] While we await further empirical evidence on this subject matter where an investor prefers its own maximisation of profits at the cost of the investee company's, the level at which such common ownership may pose a competitive risk becomes an important aspect to analyse.

At what level can common ownerships pose a competitive risk?

Minority shareholding in competing firms with rights in the nature of control or right to appoint the same individuals as directors on the boards of competing business could become problematic areas as it can have negative effects on competition, either by reducing the other shareholder's incentives to compete or by facilitating collusion.[6]

The CCI in *Ola Meru Cabs Case* mentioned that the effect of common ownership has to be established through market enquiry to determine at what level common ownership can pose a competitive risk. In India, due to the *de minimis exemption* available to enterprises under the Competition Act, 2002[7] ("**Competition Act**") from notifying a combination to the CCI, shareholding patterns of minority investors in similar markets do not come under the radar of the CCI for any scrutiny. Since the thresholds of risk in this aspect are yet to be legislated upon,[8] investors with common shareholding for

promoting good corporate governance should take precautions in such situations of conflicting interests.

Are there any precautionary measures that can be adopted by (common) institutional investors in such a scenario?

With best attempts to determine the contours of 'safe financial investments' by institutional investors, researchers from across the world have submitted various proposals to tackle this situation such as,

1. policy recommendations to limit the ownership shares of multiple firms in oligopolistic industries to 1%;
2. investee companies restricting any direct communication with the top managers of firms;[9] or
3. limit the shareholding in a competing entity to less than 15% of the share capital of such entity with no board representation and participation in normal corporate governance activities only.[10]

Since there is no definite manner to demarcate the (best) interests of an investor in such competing entities, the existing practice in several jurisdictions that investors follow is to deploy separate teams and different individuals sit on the board of each of its competing investee companies thereby avoiding any attribution towards common knowledge that could be misused. Nowadays, it is common to have specific provisions in investment agreements wherein the investors agree to not appoint the same individual as director of the investee company and its competitor and further ensure that their nominee directors abide by the confidentiality obligations under the investment agreements. This is to ensure that there is no misuse of any sensitive information provided to such investor's nominees on the board of the investee companies.

Further, under the Companies Act, 2013, every director is imposed with fiduciary duties to act in good faith to promote the objects of the company, its shareholders and the community, exercise duties with due and reasonable care with independent judgement, not have a situation of conflict (direct or indirect) with the interests of the company, and not achieve any undue gain or advantage either for himself or her / his partners, relatives. Directors appointed on the boards of competing businesses by the same investor should strictly avoid conflicting situations of their own fund's interests over the interests of the company and exercise independent judgment for the benefit of the investee company.

We believe it would be difficult to use the one size fits all approach for the aforesaid subject matter and hence there may not be a definite solution to resolve this. In order to ensure investee companies continue to benefit from the experience and knowledge that an institutional investor brings to the business of a company despite such investor's own diversification strategies, it would be helpful to contractually put in place certain safeguards on institutional investors (including investors holding minority stakes) with horizontal shareholdings such as:

1. appointment of a separate governance team in relation to each competing entity with no cross flow of information to such teams;
2. building Chinese walls between such working groups;
3. providing limited access of confidential information to common stakeholders of such investors;
4. limit the nature of influence that an investor may have over the operational decisions of the companies (including through a list of affirmative vote items).

While these may be merely suggestions in nature, the idea is of self-governance to ensure there is healthy and fair competition along with shareholder maximisation for the company while in parallel permitting investors to continue to diversify their portfolios and support emerging businesses with their expertise.

Regulation of horizontal shareholdings may become a reality in near future, given the overlap of investors start-ups have these days. However, with the theoretical ambiguities and little empirical evidence in this area, it is hoped that stringent constraints are not imposed which may negatively impact the start-up ecosystem in India and regulation, if any, should be crafted in a manner which leads to a win-win and apposite solution to all players involved in this convoluted conundrum.

– *Parag Srivastava and Poonam Pal Sharma*

[1] Meru Travel Solutions Pvt. Ltd. Informant and M/s ANI Technologies Pvt. Ltd., M/s Uber India Systems Pvt. Ltd., Uber B.V and Uber Technologies Inc. dated 20 June 2018 in Case No. 25-28 of 2017.

[2] See Note 1 above.

[3] Edward B. Rock and Daniel L. Rubinfeld, "Antitrust for Institutional Investors", New York University School of Law, available at: https://ssrn.com/abstract=2998296.

[4] See Note 3 above.

[5] José Azar, Martin C. Schmalz & Isabel Tecu, Online Appendix to: Anti-Competitive Effects of Common Ownership 2 tbl.A.1 (Univ. of Mich. Stephen M. Ross Sch. of Bus., Working Paper No. 1235, 2015). Economists Daniel P. O'Brien and Steven C. Salop have also extended the standard method of HHI (Herfindahl-Hirschman Index) used to measure competitive / anti-competitive effects, to a modified Herfindahl-Hirschman Index or MHHI formula on this subject matter. MHHI is to measure a competitor's partial ownership is used to determine the likely competition in relevant markets through share acquisitions), Daniel P. O'Brien and Steven C. Salop, "Competitive Effects of Partial Ownership: Financial Interest and Corporate Control," 67 *Antitrust L. J.* 559 (2000).

[6] Minority Shareholdings, OECD Policy Roundtables, 2008.

[7] Ministry of Corporate Affairs Notification, March 27, 2017 read with its original notification on March 4, 2016.

[8] The CCI recently published a working draft for comments including provisions on cross and common ownerships in relation to investments by pooled investment vehicles and these proposals have not been reflected in the recent amendment, Competition Commission of India (Procedure in regard to the transaction of business relating to combinations) Amendment Regulations, 2018 notified on October 9, 2018, available at:

https://www.cci.gov.in/sites/default/files/whats_newdocument/Comb.%20Amend%20Regl.2018.pdf

perhaps due to the feedback received from industry partners.

[9] Eric A. Posner, Fiona Scott Morton, and E. Glen Weyl, "A Proposal to Limit the Anti-Competitive Power of Institutional Investors," (working paper, November 28, 2016), available at SSRN: https://ssrn.com/abstract=2872754.

[10] See Note 3 above.