UNITED STATES OF AMERICA

# Federal Trade Commission

**Opening Remarks of Commissioner Noah Joshua Phillips***

**FTC Hearing #8: Competition and Consumer Protection in the 21st Century**
**Corporate Governance, Institutional Investors, and Common Ownership**

**NYU School of Law, New York, NY**
**December 6, 2018**

Good morning and thank you all for joining us today. I'm thrilled to open today's excellent slate of hearings, and to welcome the distinguished group of scholars and market participants we have with us. I'd like to give a special thanks to the FTC staff, for putting this hearing together; and to NYU Law School, for hosting the event.

I'd also like to give a special welcome to Commissioner Robert Jackson, of the Securities and Exchange Commission. Commissioner Jackson has spoken publicly about his desire to bring competition economics to the SEC, and is here with us today. I only hope that this does not augur some sort of inter-agency power grab attempt. The FTC may be older, but we're scrappy and don't shy from a fight.

Today we explore an issue in which I am particularly interested—in fact, my first public remarks as a FTC Commissioner focused on it—that is, the competitive effects and antitrust implications, if any, of "common ownership". The U.S. antitrust

* The views expressed below are my own and do not necessarily reflect those of the Commission or of any other Commissioner.

agencies define common ownership as "the simultaneous ownership of stock in competing companies by a single investor, where none of the stock holdings is large enough to give the owner control of any of these companies".[1]

Common ownership is distinct from "cross-ownership", wherein a company holds an interest in one of its competitors, and other joint venture or co-partner scenarios that have long been a focus of U.S. antitrust law.

Common ownership is a reality of the modern economy, and it is ubiquitous. Americans are increasingly utilizing the many and diversified investment options that large institutional asset managers offer. The advent of index funds, for instance, opened important avenues through which average Americans can invest their retirement savings, at a low – or zero – price. As a result of this growing demand, the trillions of dollars these companies now manage within their various funds increasingly include shares in competing enterprises.

In the last few years, economists and law professors have raised the question whether common ownership is negatively affecting competition. We have a number of them here today. I want to note especially Professor Martin Schmalz, whose work with Jose Azar and Isabel Tecu kicked off such a bevy of research and commentary that it is referred to simply as "the airlines paper".

Some concerned with common ownership have proposed remedies that are quite dramatic—according to one group of scholars, addressing the threat of

[1] US submission to OECD Hearing on Common Ownership by institutional investors and its impact on competition, at 2 (Nov. 28, 2017).

common ownership would upend "the basic structure of the financial sector",[2] for example by limiting asset managers to holding no more than 1% of a given industry unless they do so in a purely passive manner.

This debate is not just academic. Antitrust enforcers around the world are watching its development, and some are incorporating common ownership into their analyses. For instance, last year the OECD also held common ownership hearings; and European antitrust enforcers have begun citing these theories in their decisions.[3]

I find the common ownership particularly interesting because it takes place at the intersection of antitrust, corporate, and securities law and policy. In a sense, historically, this is fitting: the FTC in a way grew out of the Department of Commerce's Bureau of Corporations.[4]

In my June remarks, I noted an important way in which the intuition behind the antitrust theory of harm from common ownership runs counter to the long-standing concerns of those other bodies of law. Corporate law in particular is concerned with the ancient principal-agent problem, and ensuring that managers

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[2] Eric A. Posner, Fiona Scott Morton, & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669, 715 (2017); *see also* Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L. J. 2026 (2018); C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, at 4 (NYU Law and Economics Research Paper No. 18-29, 2018) ("These proposals, if adopted, would transform the landscape of institutional investing.").

[3] *See* Case M.7932 – Dow/DuPont, European Commission DG Competition, Commission Decision of 27.3.2017 declaring a concentration to be compatible with the internal market and the EEA Agreement, § 8.6.4-8.6.5, http://ec.europa.eu/competition/mergers/cases/decisions/m7932_13668_3.pdf ("[A]s for current price competition, the presence of significant common shareholding is likely to negatively affect the benefits of innovation competition for firms subject to this common shareholding.").

[4] Marc Winerman, *The Origins of the FTC: Concentration, Cooperation, Control, and Competition*, 71 ANTITRUST L.J. 1, 59-62 (2003).

work on behalf of shareholders, the owners of the corporation. Management neglect of minority holders is a particular concern. The common ownership theory, or at least one version of it—more on that a bit later—is concerned that managers show too much solicitude to shareholders, and in particular to certain minority holders.

In June, I identified several areas of research that I, as an antitrust enforcer, would like to see developed before shifting policy on common ownership. They were:

- How common ownership impacts a broad set of industries;
- Whether a clear mechanism of harm can be identified;
- A rationale as to why managers put the interests of one set of shareholders above the others; and
- A rigorous weighing of the harms against the procompetitive effects of institutional shareholding.

**How Common Ownership Impacts a Broad Set of Industries**

The first question stems from the fact that common ownership is so ubiquitous. Is it also ubiquitously causing anti-competitive harm, and if so, how? Professor Menesh Patel, from whom we'll also hear today, writes about the sensitivity of harm theories to various factors, including the structure of a given industry.[5] We've seen some additional research since June: one recent working paper examines common ownership and competition in the ready-to-eat cereal

[5] Menesh S. Patel, *Common Ownership, Institutional Investors, and Antitrust*, 82 ANTITRUST L.J. 279 (2018).

industry;[6] and another looks at pay-for-delay settlements in the pharmaceutical industry.[7]

I understand that economists are continuing to analyze the impact of common ownership in other industries. These studies are critical to understanding whether, and if so how, common ownership might dampen competition between rivals. The better the research behind our enforcement, the better it will be.

**Clear Mechanism of Harm**

Identifying the mechanism of harm, that is, how common shareholding *actually causes* a lessening of competition, remains a matter of robust debate. Some proponents of predicating antitrust liability on common ownership acknowledge that the "theory literature to date does not identify what mechanism funds may use to soften competition".[8] Understanding the mechanism is, however, critical to developing a coherent legal theory of antitrust harm, and ultimately to crafting an appropriate remedy.

There are, in fact, two competing theories of how common ownership leads to anticompetitive harm—for purposes of this discussion, one might call them the "active" and the "passive". The active theory involves managers affirmatively forgoing competition. Professor Einer Elhauge argues that the harm mechanism is

[6] Matthew Backus, Christopher Conlon, & Michael Sinkinson, *Common Ownership and Competition in the Ready-To-Eat Cereal Industry* (Sept. 6, 2018) (preliminary manuscript), http://www.law.northwestern.edu/research-faculty/searlecenter/events/antitrust/documents/sinkinson_cereal.pdf.

[7] Jin Xie & Joseph Gerakos, *Institutional cross-holdings and generic entry in the pharmaceutical industry* (May 10, 2018) (unpublished manuscript), http://abfer.org/media/abfer-events-2018/annual-conference/accounting/AC18P5001_Institutional_Cross-holdings_and_Generic_Entry.pdf.

[8] Scott Morton & Hovenkamp, *supra* note 2, at 2031 ("The theory literature to date does not identify what mechanism funds may use to soften competition.").

less opaque than critics claim, noting that it would "include all the ordinary mechanisms by which managers are incentivized to act in the interest of their shareholders: shareholding voting, executive compensation, the market for corporate control, the stock market, and the labor market".[9] He cites examples of when common ownership might impact how the common owners encourage the commonly-owned firms to behave. Professors Ed Rock and Daniel Rubinfeld, who disagree with Professor Elhauge about the remedies, offer a hypothetical of a portfolio manager cautioning airline companies not to expand capacity.

These types of "active" mechanisms may look like classic collusion, with which antitrust law is well familiar. And certainly where they involve active communication, the anticompetitive conduct and harm should be more easily observable. They entail real world affirmative actions to which one could point and, as such, are well-covered within existing antitrust jurisprudence. While presumably not intended to deal with competition, we have seen some asset managers work together to effectuate what they view as social responsibility, as exemplified in recent reporting about principles for firearms dealers.[10]

The second theory of harm is what one might call "passive". Professor Schmalz and others posit that, because they "own" shares in competing firms that would all benefit from a lessening of competition, common owners do not have

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[9] Einer Elhuage, *How Horizontal Shareholding Harms Our Economy—And Why Antitrust Law Can Fix It*, at 4 (Dec. 4, 2018), https://ssrn.com/abstract=3293822.

[10] Arleen Jacobius & James Comtois, *Investor coalition issues principles to improve firearms industry*, PENSIONS & INVESTMENTS (Nov. 14, 2018), https://www.pionline.com/article/20181114/ONLINE/181119921/investor-coalition-issues-principles-to-improve-firearms-industry.

incentives to push their commonly-owned firms to compete.[11] Collusion of the sort contemplated in the "active" theory can exacerbate anticompetitive effects, but is not required. This "passive" harm theory asserts that the common ownership harm derives from an absence of incentives for a shareholder to encourage a firm to action.

In a sense, the anticompetitive harm asserted here is only a species of an incentive problem endemic to the economy, to the nature of the public corporation itself. As Berle and Means long ago recognized, dispersing ownership among numerous shareholders reduces the ability and incentive of any given shareholder to exert control, such as by pressuring the firm to compete more aggressively.[12] This means not only common shareholders, but any dispersed shareholder may have "reduced" incentives to pressure a firm to compete.

Professor Elhauge notes that the benefits from "softened" competition may also be shared broadly among shareholders, as it increases firm profits, for example in oligopolistic markets.[13] So while dispersed shareholders may lack an incentive to encourage competition in general, that may especially be the case if we can assume they are affirmatively benefitting from oligopolistic pricing and profits.

This passive theory raises interesting issues. First, it appears to be in tension with some of the remedies proposed to address common ownership—which offer up,

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[11] *See, e.g.,* Martin C. Schmalz, *Common Ownership and Competition: Facts, Misconceptions, and What to Do About It*, OECD Hearing on Common Ownership by institutional investors and its impact on competition, ¶¶ 20-21 (Dec. 6, 2017); Elhauge, *supra* note 9, at 4 ("[H]orizontal shareholding can decrease competition through the even simpler mechanism of reducing the incentives of shareholders to pressure managers to compete.").
[12] ADOLF A BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 114 (Transaction Publishers 1991) (1932).
[13] Elhauge, *supra* note 9, at 44-45.

for instance, "pure passivity" as a solution. If passivity itself is the problem, it can hardly be the solution as well.

Second, at a time of concern about a lack of competition in the economy generally, is chilling shareholder input the right move? Should we not be considering mechanisms that would encourage companies to compete? The Hart-Scott-Rodino Act explicitly exempts from filing requirements acquisitions made "solely for the purpose of investment", which the antitrust agencies have interpreted to mean as applying to purely passive shareholders.[14] If we don't get enough encouragement to compete, is that right approach?

Henry Manne explained that the market for corporate control helps to rectify the disparate power and incentives of firm managers versus shareholders, and affords "to these shareholders both power and protection commensurate with their interest in corporate affairs".[15] Actions that undermine the effective operation of the market for corporate control, including antitrust policy that fails to consider this market, may prove very harmful to investors, but also to consumers.

Third, how can we identify the marginal, and purportedly negative, effect of common ownership where shareholders already have little incentive to encourage the firm to compete more aggressively, and maybe less given the structure of a given market? Consider liability under Section 7 of the Clayton Act—a theory propounded in the common ownership literature—where acquisitions are only

[14] 15 U.S.C. § 18a.
[15] Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965).

unlawful if they are likely *substantially* to lessen competition. At what point do the effects of a share acquisition meet that threshold?

Whichever theory you subscribe to, or scares you, I look forward to today's discussion of the evidence. I'd be remiss not to mention two of our hosts, Professors Scott Hemphill and Marcel Kahan, who conclude thusly with regard to the mechanisms of harm: "First, several mechanisms in the literature are not, in fact, empirically tested. . . . Second, some mechanisms are ineffective in raising portfolio value or would pose major implementation problems for [common concentrated owners (CCOs)]. Third, because most institutional CCOs have only weak incentives to increase portfolio value, they are likely not to benefit from pursuing mechanisms that carry significant reputational costs or legal liability".[16]

**Rationale regarding Managers' Responsiveness to Shareholders**

The third question I raised in June was asking for a rationale regarding managers' responsiveness to shareholders, and certain ones apparently over others. This is another context where the assumptions underlying common ownership run up against assumptions underlying other legal regimes. If the principal-agent problem concerns you, and you think about shareholder neglect—or, put differently, too *little* competition—understanding how shareholders and managers behave is critical to ensuring we have coherent legal regimes that accurately capture harmful behavior and encourage beneficial behavior.

Common ownership presumes that managers are attuned to the particular desires of a minority of their shareholders and act to maximize value to those

[16] Hemphill & Kahan, *supra* note 2, at 1.

shareholders; whereas corporate law assumes managers, unless forced to behave otherwise, will act to maximize their own interests over that of the shareholders generally, and of minority shareholders specifically. So, in a real sense, corporate law tends to worry very much that managers will not be responsive enough to their shareholders, while common ownership theories presume loyalty to a select few—often passive—investors.

Professors Azar and Elhague point to modeling demonstrating that, if managers seek to maximize expected share of votes or likelihood of being re-elected, then they will seek to maximize the weighted average of their shareholders' profits from all their shareholdings.[17] This model also demonstrates that shareholder variation in levels of common ownership will "alter[] the precise weight managers put on each shareholder".[18] But skeptics have raised questions as to the practical application and real-world predictability of such models. Are managers so acutely attuned to the shareholding levels and desires of their various shareholders? Do they respond in precise fashion to those changing shareholding levels and desires?[19] Do boards and senior managers of major companies even get involved in decisions about issues like price?

[17] Elhauge, *supra* note 9, at 8 (citing José Azar, *Portfolio Diversification, Market Power, and the Theory of the Firm*, at 12-14 (Aug. 23, 2017), https://ssrn.com/abstract=2811221).
[18] Elhauge, *supra* note 9, at 8-9.
[19] *See, e.g.*, Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, at 235-6 (NYU Law and Economics Research Paper No. 17-23, 2017).

As noted earlier, common ownership theory proponents have responded, in part, that non-common shareholders might likewise benefit from softer competition, and so managers are not actually acting against the interests of most holders.[20]

But, again, if all, or most, shareholders benefit from soft competition such that none have incentives to actively encourage the firm toward more aggressive competition, what additional impact do common owners add?

Much of this comes down to what shareholder incentives actually are. There are reasons why they might prefer softer competition. But there are also reasons why they might not. For instance, if they are diversified across industries, as investors in customers to those setting oligopoly prices, they might not always benefit from oligopoly pricing in discrete industries. The answer can only be complex, measuring those harms against the gains from softening competition. What's an asset manager to do? To the extent the answers are nuanced – different shareholders with different preferences, incentives changing frequently over time – to the corporate manager, isn't competition the safest, and most legal, bet?

Another issue: in my remarks thus far, I've been a little irresponsible in using words like "own". Some are investment advisors or investment managers are "beneficial owners" but are not the economic owners of the shares.[21] Professors Hemphill and Kahan criticize "the empirical literature to date [as paying] insufficient attention to the systematic differences in the incentives of different

[20] Elhauge, *supra* note 9, at 44.
[21] *See*, *e.g.*, Douglas H. Ginsburg & Keith Klovers, *Common Sense about Common Ownership*, 2 CONCURRENCES REV. (May 2018); Hemphill & Kahan, *supra* note 2, at 42.

investor types."[22] They find that "the empirical literature fails to take account of the possibility that investor types likely to be [common concentrated owners (CCOs)] have systematically lower incentives to get involved than investor types likely to be nonconcentrated owners."[23] They explain that while the literature assumes the common owners' objective is to raise portfolio value, the "archetypal CCO, the investment advisor, has incentives quite unlike those of an individual who holds the ownership stakes", and has only weak incentives to increase portfolio value.[24] How do these facts factor in?

**Rigorously Weighing the Procompetitive Effects of Institutional Shareholding**

My final question is June was, for policy-makers, how to weigh the benefits of the kind of institutional investment we see today. Several scholars debating the common ownership question have acknowledged that various proposals would alter "the basic structure of the financial sector"[25] and "transform the landscape of institutional investing."[26] Such tectonic policy shifts should not be undertaken lightly.

Large institutional investors have, in many ways, made investing affordable for the average American. Index funds, for instance, have nominal to no fees. And the returns are nothing at which to laugh. Such investing opportunities were unheard of before the second half of the twentieth century. When considering

[22] Hemphill & Kahan, *supra* note 2, at 8-9.
[23] *Id.*
[24] *Id.* at 41-42.
[25] Posner et al., *supra* note 2.
[26] Hemphill & Kahan, *supra* note 2, at 4.

policies that could find index funds as they exist today are fundamentally incompatible with antitrust laws, we need to keep these very real benefits in mind. Many Americans simply do not have the funds available to buy into more expensive investments.

Scholars have also placed great hope in large, sophisticated institutional investors to have the incentives to make corporate governance better. Are they doing so? I look forward to hearing about stewardship practices today, and how their development should be considered in this context. John Bogle, the inventor of the index fund, wrote last week about his concern that too few people control corporate governance in America.[27] Are those concerns valid, and how should they factor in—if at all?

**Conclusion**

The common ownership discussion has remained vigorous since last I had the opportunity to speak publicly about it. I am heartened to see that serious scholarship continues to examine critically the theories and empirics at play, and pleased the FTC has included this topic in the hearings. Our panelists today will grapple with a number of intriguing questions, and I'm excited to hear from them all.

[27] John C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL STREET JOURNAL (Nov. 29, 2018), https://www.wsj.com/articles/bogle-sounds-a-warning-on-index-funds-1543504551.