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Proposal To Remedy Horizontal Shareholding Is Flawed

By **Elaine Buckberg, Steven Herscovici, Branko Jovanovic and James Reitzes**

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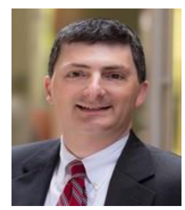
Several recent studies claim to show that competition is adversely affected when institutional investors hold significant shares in multiple firms within a “concentrated” industry, leading to higher prices and other effects.[1] Following on this research, Eric Posner, Fiona Scott Morton and E. Glen Weyl have proposed a remedy that would allow institutional investors to hold shares in only one company in a concentrated industry, or to limit their shareholdings to no more than a 1 percent total equity stake in the industry when holding shares in multiple companies. They also propose a “safe harbor” for stand-alone “purely passive” index funds that commit both to having no contact with management of companies whose shares they own, and to voting their proxies in proportion to other shareholders’ votes.

Elaine Buckberg

We believe that the empirical literature cited by Posner et al. in support of competitive harm from horizontal shareholding is far from definitive and suffers from potential flaws. As such, there are doubts whether horizontal shareholding creates a competitive problem that justifies invoking a particular blanket “remedy,” as opposed to a case-by-case analysis and more selective remediation. Analysis of the costs of the proposed blanket solution, which may be substantial (as we detail below), is lacking.



Steven Herscovici

Posner et al. argue that their proposed remedy would increase competition, while not adversely affecting the public, because it would still allow investors to hold mutual funds that are diversified across industries (as opposed to within an industry) or achieve full diversification via purely passive index funds. Their analysis of the proposal’s cost underestimates the disruption it is likely to create for investors and financial markets.

Branko Jovanovic

As explained below, the proposed rule would place increased burdens on investors, financial advisers and intermediaries (who would have to reconstruct portfolios and fund platforms based on proposed limitations imposed on investment advisers), raise transactions costs (as investment advisers sell assets and investors sell fund shares in response to the limitations), and possibly force funds to hold more short-term assets (e.g., when switching equity holdings between companies in a concentrated industry).

James Reitzes

Good public policy requires carefully considering how a proposal may affect stakeholders. The proposed rule would have important, adverse consequences for many households’ ability to accomplish their long-term financial goals, such as saving for retirement, education, homeownership or other purposes. As such, the proposal would go against a number of bipartisan public policy objectives.

The Proposed Remedies Lack Adequate Definition

Posner and co-authors may be proposing a solution to a problem that does not exist. But they propose to solve it by promulgating a simple rule: In any concentrated industry, an "investor" may be allowed to hold either (1) a total industry ownership stake no larger than 1 percent, or (2) shares in only a single effective firm.[2] As noted above, purely passive index funds would be exempt.[3]

Key implementation questions are unanswered. The paper fails to define "investor" with enough precision to know which entities are covered by the rule. As a practical matter, any definition will be determined by government agencies and heavily litigated in courts. Will the 1 percent limit be applied to all holdings managed by an asset management complex, or only those where the firm has the right to vote the shares? Will separately managed accounts for institutional investors (e.g., pension funds) count against the limit?

The paper fails to establish workable criteria for identifying industries covered by the rule. Posner et al. propose that the U.S. Department of Justice and the Federal Trade Commission would annually compile a list of industries to be designated as "oligopolies," along with company market shares within those industries.[4] Posner et al. do not answer questions critical to determining how fund managers would be restricted: How would "concentrated industries" be defined, and how would the companies in them be identified?[5] What is the relationship between the identification of concentrated industries and the traditional antitrust identification of relevant markets, which is used to assess the potential competitive effects of mergers and acquisitions and "monopolizing" firm practices alleged to preserve or enhance market power?

If certain industries (e.g., airlines) are determined to be concentrated, identifying competitors might not be too difficult. However, in other industries, determining which firms are horizontal competitors may be more difficult. For example, Apple and PayPal both offer e-payment services. Do they compete in the technology industry? In the financial services industry with Visa and MasterCard? If so, do they also compete with JPMorgan Chase and other credit card issuers? For the purposes of meeting the thresholds, would the market be defined solely in terms of U.S. companies, or would foreign competitors also be included?

The DOJ and FTC frequently collect and analyze significant amounts of data in defining relevant markets in merger cases. Requiring the antitrust authorities to do so for potentially relevant markets where horizontal shareholding may pose no significant anti-competitive issues would be a poor use of the agencies' limited resources.

The Disruptions That the Proposal Would Cause to Asset Managers Would Harm Customers

The 1 percent threshold would have a profound impact on investors and the equity markets. Investors benefit from the broad offerings of mutual fund complexes in several ways. For example, investors can assemble a broadly diversified portfolio consisting of complementary funds within a single fund complex. Many fund complexes have broad offerings from which investors can compose a portfolio of active funds, index funds or a combination. Under the proposed rule, fund complexes would be able to offer only purely passive index funds or active funds, not both, unless the holdings of the entire fund complex remained under the 1 percent threshold.[6]

Ultimately, the proposed rule would reduce active managers' discretion and nimbleness. Under the proposed rule, a fund complex would have to choose whether to invest in a single firm in any industry deemed to be concentrated, or remain under the 1 percent threshold. Larger fund complexes would constrain individual fund managers to invest in only a single firm in an industry — and that industry would be chosen at the complex level, not chosen by the specific fund manager.

This restriction limits the ability of a fund complex to offer investors diversified industry exposure, either as a way of managing volatility or expressing a view that a particular industry is likely to outperform the market generally. This limitation is particularly problematic in that it would apply to the holdings of all funds across all investment objectives. Complexes would need to develop centralized approaches to selecting stocks in concentrated industries to ensure compliance with the threshold. This would stand in stark contrast to the asset management industry's current practice of granting a portfolio manager broad discretion to manage a fund independently, consistent with the fund's prospectus.

In particular, such centralized stock selection for concentrated industries would reduce the ability of fund complexes to offer a broad range of funds with different mandates. Consider the credit card industry. At one fund complex, several growth funds hold Visa among their top 10 holdings, whereas a value fund within the same complex counts Discover as one of its top 10 holdings. Under the Posner et al. proposal, the fund complex would be forced to either hold only one of Visa or Discover, or reduce its combined holdings of the industry below the 1 percent threshold. Similarly, suppose that a fund manager believes the biotech industry is underpriced and would like to invest in a diverse portfolio of the companies in this industry. In order to conform to the 1 percent limit, the fund managers would be forced to invest in only one company.

The Proposal Also Would Cause Market Disruptions That Would Harm Investors

The proposal could disrupt markets to the detriment of funds and other investors. Fund traders take care to minimize the price impact of their trades by gradually moving into and out of positions without allowing other market participants to learn of their trading intentions. Consequently, mutual funds often buy or sell shares over an extended period of time. If an asset manager decides to change its chosen stock in a concentrated industry, the total size of the positions the fund or complex is selling and acquiring may affect market prices for those companies, impairing investor returns.

As a practical result, the rule would make it nearly impossible for large asset managers to change which firm they hold in a concentrated industry while still offering their clients consistent market exposure over time. During the time the fund complex takes to unwind the existing position and subsequently build its position in the preferred company, all affected funds would have to hold more cash and have less exposure to the industry in question than they otherwise would choose.

Costs of Breaking Up Asset Managers

Fund families would have to either significantly reduce their assets under management to avoid exceeding the 1 percent threshold — or develop a business model that enables them to hold a stake in only a single effective firm. Any fund complex wanting to offer a diversified set of funds to investors would be forced to remain small enough that its total holdings in any concentrated industry would not reach the 1 percent threshold. Effectively, this would force large active asset managers to break up.

Asset managers might attempt to comply with the 1 percent threshold in a number of ways. Some may offer a limited but diversified set of mutual funds; others may choose to offer a single fund at a larger scale.

Changing the mutual fund landscape, however, would be costly for investors and companies running 401(k) plans, both in the transition and over time. Consumers directing their own individual retirement account, Roth IRA, 529 plan or other accounts may have to spread investments across multiple fund complexes to gain full diversification.

Some consumers' portfolios would be less well-managed as a result, either less diversified or less frequently rebalanced, if at all. Rebalancing across fund families would be more time-consuming, likely making many consumers rebalance less frequently, if at all. Similarly, 401(k) plans would need to reconsider their menu of fund options in light of changing fund complex offerings and changing fees.

Alternative Approaches May Be Less Disruptive

Even if further peer-reviewed research ultimately points to anti-competitive effects from common ownership in certain industries,[7] it will be important for policymakers to remedy the anti-competitive effects while minimizing the restrictions placed on fund complexes. For example, Edward B. Rock and Daniel L. Rubinfeld propose creating a safe harbor for investors with stakes smaller than 15 percent, no board representation, and "normal" corporate governance activities focused on best practices such as board composition and governance, transparency and executive compensation. Rock and Rubinfeld argue that this approach would match the Hart-Scott-Rodino "solely for investment" standard which applies if the investor "has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer."[8]

Although the full impact of the Rock and Rubinfeld "solely for investment" proposal would need to be fully analyzed, it appears to have two important advantages over the Posner et al. approach: asset managers could maintain industry exposure without being forced to pick a single winner in each concentrated industry and they could avoid disruptions associated with changing holdings or approaching a threshold. Allowing institutional investors to continue contributing to basic corporate governance would also benefit consumers and shareholders.[9]

Conclusion

Posner et al. propose a costly and disruptive way to change asset manager behavior that would impair households' ability to accomplish their long-term financial goals — despite the weak evidence that institutional cross-holdings may be a source of anti-competitive behavior. More research on whether institutional holdings are related to reduced competition is needed first. Even if that proves out, the goal of any remedy should be to mitigate anti-competitive behavior while minimizing the costs associated with achieving efficiency-enhancing investment objectives. We believe the remedy, as proposed, does not do so.

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[1] Jose Azar, Martin Schmalz and Isabel Tecu, “Anti-Competitive Effects of Common Ownership,” Working Paper, March 2017; see also Jose Azar, Sahil Raina, Martin Schmalz, “Ultimate Ownership and Bank Competition,” Working Paper, July 2016. The findings of Azar et al. are hardly conclusive, however. O’Brien and Waehrer argue that Azar et al. have identified only correlations between prices and measures of concentration modified to take into account the effects of common ownership, and that these correlations “have no clear implication for the effects of common ownership on prices and do not form a reasonable basis for policy, let alone the major changes in policy that some have proposed.” See Daniel P. O’Brien and Keith Waehrer, “The Competitive Effects of Common Ownership: We Know Less Than We Think,” Working Paper, February 2017, p. 6. Furthermore, Novick et al., argue that “some of the economic papers use data filed for the purposes of regulatory reporting of shareholdings under various national security laws to identify common owners of companies. This data is, however, fundamentally unsuitable for identifying economic ownership, as asset managers are not the owners of the assets they manage, but rather act as agents on behalf of multiple clients.” See Barbara Novick, Michelle Edkins, Gerald Garvey, Ananth Madhavan, Sarah Matthews and Jasmin Sethi, “Index Investing and Common Ownership Theories,” BlackRock Viewpoint, March 2017, p. 7,

[2] The authors define an effective firm as either a single firm, or alternatively a stake in multiple firms that have a combined market share less than the “average size” firm in the industry (which they define as Industry HHI/10,000). Posner et al., p. 34.

[3] Going forward, we use “investment funds,” “mutual funds,” “fund complexes” and “asset managers” to refer to all funds other than purely passive index funds and the firms that manage them; similarly, “investors” refers to investors in any nonpurely passive fund.

[4] Posner et al., p. 34.

[5] Rock and Rubinfeld point to another unanswered question in an earlier draft of Posner et al.: “How does one characterize multiproduct firms? ... Which are the firms that they must choose from and who will decide? How will foreign firms be treated?” See Edward B. Rock and Daniel L. Rubinfeld, “Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance,” Working Paper, March 2017, p. 25.

[6] Novick et al. argue that proposed policy changes “would significantly inhibit the strategies of pension funds, institutional accounts, retirement plans and individual accounts, which use asset managers’ services to help deliver their long-term investment objectives. They would also flout principles of diversification encouraged in regulations, which have long recognized index investing as a valid means of diversifying at a low cost.” See Novick et al. (2017), page 13.

[7] In recent papers, Vives and Woodbury emphasize the need for further research. Vives observes that “it is still early to advance and implement major changes in regulation and antitrust enforcement. Before that we need to have a better understanding of the channels of transmission of ownership patterns into competitive outcomes, via corporate governance” and that “more empirical evidence of consumer harm and the effects on innovation.” Xavier Vives, “Institutional Investment, Common Ownership and Antitrust,” CPI Antitrust Chronicles Volume 1, No.3 (2017), available at https://www.competitionpolicyinternational.com/institutional-investment-common-ownership-and-antitrust, p. 3 Similarly, Woodbury states that “There should be little doubt that further research should

be pursued by these and other researchers to validate (or not) the anticompetitive effect and the generality of that effect of shareholdings by institutional investors. If that effect is robust, it could justify significant changes in policy. But it would be premature and potentially very costly to do so without that further evidence." John Woodburry, "Can Institutional Investors Soften Downstream Product Market Competition," CPI Antitrust Chronicles Volume 1, No.3 (2017), available at https://www.competitionpolicyinternational.com/can-institutional-investors-soften-downstream-product-market-competition, p. 9.

[8] See Rock and Rubinfeld (2017), p. 33.

[9] However, as Patel (2017) points out, "there is insufficient economic theory or empirical analysis to know with reasonable certainty where the necessary lines should be drawn." Patel also recognizes that "there is some intuitive appeal to establishing an antitrust safe harbor or a presumption of insubstantial competitive effects for common ownership amounts not exceeding a set threshold in a given relevant market." Menesh Patel, "Common Ownership, Institutional Investors, and Antitrust," Working Paper (2017), p. 62.

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