<u>Submitted online via regulations.gov</u>

December 6, 2018

Office of the Secretary
Federal Trade Commission
600 Pennsylvania Avenue NW
Suite CC-5610 (Annex C)
Washington, DC 20580

Re: FTC Hearing #8: Competition and Consumer Protection: Holdings of Non-Controlling Ownership Interests in Competing Companies

Dear Mr. Secretary:

Thank you for the opportunity to present our views on theories of anticompetitive effects from holdings of non-controlling ownership interests in competing companies.[1]

The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management exceeding $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $25 trillion in assets under management.[2]

CII's asset owner members have diversified portfolios with diversified assets, including U.S. and non-U.S. equity, fixed income, real estate, private equity, venture capital, liquidity products and other alternative investments. Some investments are internally managed by funds, but a larger portion is externally managed by asset management firms.

Considering both internally managed and externally managed assets, CII asset owner members' largest single asset class consists of equity in companies listed on stock exchanges, with a majority of these assets in U.S. companies.

[1] See https://www.ftc.gov/news-events/events-calendar/ftc-hearing-8-competition-consumer-protection-21st-century
[2] For more information about the Council of Institutional Investors ("CII"), including its members, please visit CII's website at http://www.cii.org/members.

Institutional Shareowner Responsibilities on Corporate Governance

CII asset owner members strongly believe that shareowners—including pension funds and other asset owners, as well as the asset managers they hire—have critical responsibilities in corporate governance. Institutional shareowners should vote and engage as necessary with company management and boards, in order to promote accountability, well-functioning boards and effective corporate governance more generally.[3]

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[3] CII policies on corporate governance and other matters have been developed over the last 33 years, and are approved by members. See https://www.cii.org/policies. CII's Policies Committee, which consists of non-officer members of the CII board (listed at https://www.cii.org/board_of_directors), is responsible for policy development, which includes comment and review of potential revisions by the membership before changes come up for membership vote. The *CII Policies on Corporate Governance* are particularly relevant to this letter, and were last amended by CII members in October 2018. *CII Policies on Corporate Governance* include the following (boldface added and bullet format used for readability):

- CII believes effective corporate governance and disclosure serve the best long-term interests of companies, shareowners and other stakeholders. **Effective corporate governance helps companies achieve strategic goals and manage risks by ensuring that shareowners can hold directors to account as their representatives**, and in turn, directors can hold management to account, with each of these constituents contributing to balancing the interests of the company's varied stakeholders….
- **CII supports shareowners' discretion to employ a variety of stewardship tools** to improve corporate governance and disclosure at the companies they own. These tools include casting well-informed proxy votes; **engaging in dialogue with portfolio companies** (including with board members, as appropriate), external managers and policymakers; filing shareholder resolutions; nominating board candidates; litigating meritorious claims; and retaining or dismissing third parties charged with assisting in carrying out these activities….
- **Shareowners should have meaningful ability to participate in and vote on the major fundamental decisions that affect corporate viability**….
- **CII encourages companies** to resist both internal and external short-term pressure and thinking, to prioritize creating sustainable value over the long run through long-term investment and **to engage with shareholders with long-term ownership and investment horizons**….
- Boards should take actions recommended in shareowner proposals that receive a majority of votes cast for and against….
- **Directors should respond to communications from shareowners and should seek shareowner views on important governance, management and performance matters**. To accomplish this goal, all companies should establish board-shareowner communications policies. Such policies should disclose the ground rules by which directors will meet with shareowners. The policies should also include detailed contact information for at least one independent director (but preferably for the independent board chair and/or the independent lead director and the independent chairs of the audit, compensation and nominating committees). **Companies should also establish mechanisms by which shareowners with non-trivial concerns can communicate directly with all directors**…. Boards should determine whether outside counsel should be present at meetings with shareowners to monitor compliance with disclosure rules.
- **All directors should attend the annual shareowners' meetings and be available, when requested by the chair, to answer shareowner questions**. During the annual general meeting, shareowners should have the right to ask questions, both orally and in writing. Directors should provide answers or discuss the matters raised, regardless of whether the questions were submitted in advance. While reasonable time limits for questions are acceptable, the board should not ignore a question because it comes from a shareowner who holds a smaller number of shares or who has not held those shares for a certain length of time….
- The board should disclose to shareowners, at least annually, sufficient information to enable them to assess whether the board is carrying out its oversight responsibilities effectively….
- **A shareowners' right to vote is inviolate and should not be abridged**….
- **Each share of common stock should have one vote**. Corporations should not have classes of common stock with disparate voting rights. Authorized, unissued preferred shares that have voting rights to be set by the board should not be issued without shareowner approval.

The history informing our perspective is worth review, given the issues under consideration at this FTC hearing. CII was formed in 1985 by public pension funds concerned primarily with deficiencies in corporate governance at listed U.S. companies. The immediate impetus: certain aggressive investors with short-term time horizons at that time were challenging U.S. companies, often in pursuit of narrow interests that did not serve shareholders generally. Most notably in some cases, certain holders sought "greenmail" payoffs at the expense of long-term patient holders such as pension funds. Company boards and management responded by further shielding themselves in ways that entrenched management and limited accountability to shareholders, such as through so-called "shareholder rights plans" (i.e., poison pills), staggered election of directors and unequal voting rights. CII founders believed that the interests of long-term pension fund investors were getting lost in the shuffle.

There was a longer-standing, even more troubling set of factors that led to the formation of CII. Public pension funds in the 1980s were concerned that while U.S. public companies were quick to defend management prerogatives, boards of directors were generally weak, poorly functioning and insufficiently oriented to building long-term shareholder value. Too often, U.S. public company boards were "rubber stamps." Complacent boards and managers were slow to address problems and update business practices even as global competition increased and the pace of change in market dynamics accelerated. And dispersed ownership had created a collective action problem such that "agents," boards and management, were insufficiently disciplined in promoting the vitality of their enterprises and building long-term value for their "principals," the shareholders.

For these reasons, CII founders believed that pension fund investors and their asset managers – who have clear fiduciary obligations to clients – needed to be vocal with company management and boards to promote long-term shareholder value and the interests of pension participants. Extreme passivity (just putting shares in the drawer) was no longer acceptable.

The efforts of pension funds and other asset owners to get their asset managers to play an appropriate oversight role at portfolio companies have proven long and difficult; the mission is not yet fully accomplished. Since 1985, many asset managers' practices on shareholder engagement have improved dramatically from the standpoint of CII and our members, who have zero interest in returning to the suboptimal old days of extreme passivity. But our members remain concerned that some of their managers continue to err on the side of passivity and excessive deference to management, if only because engagement with entrenched management and complacent boards can take some effort, incur costs, and ruffle feathers (sometimes of potential asset management firm clients). We worry that just the debate on common ownership will encourage some asset managers (especially those that only now are stepping up) to revert to the easier approach – "put the share in the drawer and don't rock the boat." And of course, the policy "solution" of stripping index investors of their proxy votes would force asset managers to again become passive owners.

Over the last few decades the trend toward index investing has intersected with the push toward more engaged ownership. Pension funds and some other asset owners turned increasingly to indexing and other quantitative strategies to reduce costs and maximize returns. Index investing at low cost offers benefits of diversification in providing risk-adjusted returns over the long term.

As with active managers, our members expect the asset managers they retain for index investing to have strong corporate governance programs, including voting policies and practices that promote the long-term interests of shareowners, and engagement with portfolio companies. As both pension funds and index managers have very long time-horizons, or can be considered "forever investors" and "universal owners," their interests can align particularly well, but only to the extent that index managers are willing to step up on these issues.

Different asset owners have different expectations for the range of environmental, social and governance (ESG) matters to be addressed through company-shareowner engagement, which is a consideration in manager selection and often addressed in contractual arrangements with asset managers. But across the board, our members expect their asset managers (including those following index strategies) to be engaged and to have thoughtful voting policies and practices on the full range of ESG issues. If an asset manager were prohibited from proxy voting and engagement, our members would see that as a serious disability in delivering long-term value to their funds. We wholeheartedly agree with the assertion by Edward Rock and Daniel Rubinfeld in a recent paper that, "Surely, in a sound corporate governance system, we want the largest shareholders to engage in direct discussions with corporate management and to use their votes to influence managers."[4]

The "Common Ownership" Hypothesis

With no convincing evidence yet on a mechanism by which "common ownership" promotes anti-competitive behavior, much of the literature suggests (without specific evidence) that corporate managers must be restraining competition simply from the knowledge that some of their largest holders also own stock in their competitors. In June 2018 comments, Commissioner Noah Joshua Phillips of the Federal Trade Commission (FTC) said, "[A]s intuitions go, this is rather counter-intuitive." We wholeheartedly agree. Phillips continued:

> [T]he theory of corporate behavior underlying the harm from common ownership runs contrary – directly contrary – to our ancient and well-established concerns about the relationship between managers and shareholders…. [Adam Smith, Adolf Berle, Gardiner Means, Michael Jensen, William Meckling and others addressed] the cost of agency, that is, the problem of aligning the incentives of the principal – the shareholders of a corporation – with their agents – the managers. The existence of the problem…remains with us today. The distinction between ownership and control is fundamental, and fundamentally problematic. But not in the direction that would reinforce the common ownership story.
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> For centuries, literally, we have concerned ourselves with the problem of making managers care more about shareholders – precisely because there are innumerable reasons to fear that they do not.[5]

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[4] Edward B. Rock and Daniel L. Rubinfeld, "Antitrust for Institutional Investors," 82 *Antitrust Law Journal* No. 1 (2018), at 273.

CII has reviewed recent papers asserting that "common ownership" damages competition, and we find those papers unconvincing.[6] Moreover, proffered "solutions," such as essentially prohibiting index investing by larger firms or eliminating voting rights for large index investors, would be highly disruptive to asset management by adding significant costs and subtracting desirable investment options for institutional and retail investors alike, and highly damaging to corporate governance and shareholder accountability.[7]

The academic debates aside, we join Commissioner Phillips in finding the common ownership theory counter-intuitive. First, it is not at all clear to us, for reasons mentioned above, that non-controlling holders – particularly index investors – exercise undue power or hold decisive sway in the minds of corporate managers. If anything, they remain too cautious in asserting views with portfolio companies from the perspective of many of our asset owner members.

Second, we note that index investors are sometimes called "universal investors," as, except for relatively limited sector funds, they own the entire universe of publicly held companies. Even aside from the complete lack of evidence, it does not stand to reason that a universal owner would encourage anticompetitive behavior in certain industries (e.g., airlines and banks) at the expense of other companies in their portfolios and to the economy more generally.

Third, in discussions with CII members and other large institutional investors on effective shareholder-company engagement practices, a strong takeaway is that most engagement on execution and strategy encourages managements and boards to compete better ("run faster and jump higher"), not the reverse. This includes conversations, which now are extensive, on executive compensation. Many larger managers have expressed a strong preference in recent years for <u>relative</u> performance as measured against peers and the particular industry. There have been loud arguments, particularly in the last seven years since shareholder "say-on-pay" votes were mandated in the United States, between company managers, investors and proxy advisors on the appropriate peer groups for measuring performance of companies.[8] When evidence emerged that some companies set biased peer groups in order to pay their executives more, institutional investors became even more vocal. Assuming that institutional investors believe that executives care about their own incentives, it does not make sense that they would put so much emphasis on relative performance measures in benchmarking executive pay if they were discouraging collusive behavior within industries.[9]

In our understanding, relatively little engagement by asset manager corporate governance teams is aimed specifically at affecting corporate strategy as such. Aside from executive compensation,

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[6] Miguel Anton, et al., "Common Ownership, Competition, and Top Management Incentives," *Ross School of Business* No. 1328 (2018); Jose Azar, Martin C. Schmalz and Isabel Tecu, "Anticompetitive Effects of Common Ownership," *Journal of Finance* 73(4) (2018);.

[7] Einer Elhauge, "Horizontal Shareholding," 129 *Harvard Law Review* No. 5 (2016); Eric A. Posner, Fiona M. Scott Morton and E. Glen Weyl, "A Proposal to Limit the Anti-Competitive Power of Institutional Investors," *Antitrust Law Journal* (forthcoming) (2017).

[8] 97% of S&P 500 companies disclose benchmarking peer groups, according to ISS. See Subodh Mishra, "Peer Selection and the Wisdom of the Crowd: Considerations for Companies and Investors," at https://corpgov.law.harvard.edu/2018/06/26/peer-selection-and-the-wisdom-of-the-crowd-considerations-for-companies-and-investors/.

[9] Heung Jin Kwon, "Executive Compensation under Common Ownership," *University of Chicago* (2016).

the biggest focus for engagement by asset manager corporate governance teams with companies is aimed at understanding whether governance is effective. These teams seek to understand board processes in setting strategy, considering risk, comprehending corporate culture and oversight of management (e.g., does the board act independently of management?). A particular investor focus in engaging with independent directors is to understand whether board members are informed and "awake at the switch." All of this is because investors view boards as the critical fulcrum for governance, and they want to be able to rely on them. The investors generally hope to steer well clear of micromanagement. To the extent that indexed investors discuss strategy with executives and board members, they seek to understand what the strategy is, how it is reviewed and whether the approach appears consistent (e.g., are executive compensation practices linked to strategy?).

Finally, we believe that some of the common ownership research does not adequately reflect aspects of modern asset management. For example, asset owners, including many of our members, retain voting authority for shares in their separate accounts, so the large indexers control fewer votes than their Securities and Exchange Commission (SEC) filings show for beneficial share ownership. A second example: active investor ownership of multiple companies within an industry does not mean the asset manager is not betting on one or a few of those companies. Often, particular companies are overweighted or underweighted in a portfolio, with some exposure to underweighted companies (rather than zero exposure) intended to modulate the level of risk. A third area where understanding may be insufficient: the asset management firm owes a duty to participants in each individual fund managed by that firm, and does not necessarily vote shares with a single purpose. Asset managers may split their votes, reflecting varying financial interests of different accounts or conflicting views of different individual portfolio managers or teams.[10] There are other complexities in asset management that also do not seem to be reflected in some of the papers we have seen.

We recognize that there is growing literature on various sides of common ownership debates. We will not review the literature here, other than to note that a number of thoughtful papers cast considerable doubt on alleged evidence of negative effects from common ownership, and in our view are more persuasive than papers arguing for the theory of common ownership.[11] Moreover, we believe there are serious questions on the theory given the lack of a clear and compelling explanation of a mechanism by which common ownership is inhibiting competition.

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[10] For example, if there is agreement at an investment firm that one company is overpaying for an acquisition of another company in the portfolio, the investment manager should be expected to support the acquisition in funds with heavy relative weightings in the firm being acquired, and oppose it where weightings are with the acquiring company.

[11] See, e.g., Rock and Rubinstein, op. cit.; Patrick J. Dennis, Kristopher Gerardi and Carola Schenone, "Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry," (2018); Douglas H. Ginsburg and Keith Klovers, "Common Sense About Common Ownership," *Concurrences Review* No. 2-2018 (2018); Jacob Gramlich and Serafin Grundl, "Testing for Competitive Effects of Common Ownership," Finance and Economics Discussion Series 2017-029, *Board of Governors of the Federal Reserve System* (2017); Thomas A. Lambert and Michael E. Sykuta, "The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms," Research Paper No. 2018-21,University *of Missouri School of Law* (2018); Daniel P. O'Brien and Keith Waehrer, "The Competitive Effects of Common Ownership: We Know Less than We Think," (2017); Manesh S. Patel, "Common Ownership, Institutional Investors, and Antitrust," *Antitrust Law Journal* (forthcoming) (2018).

SEC and FTC Policies

While the SEC and FTC missions differ, we would hope that policies from the two agencies would harmonize. In this regard, we note that SEC policies promote shareholder engagement, for example, through rules around proxy voting, as well as the shareholder proposal rule. And the concept of the "passive investor" in SEC rules has kept pace with changes in the corporate governance landscape over the last 40 years, recognizing that in normal course, it is to be expected that investors will communicate with companies, while permitting qualified institutional investors to file on the short-form 13G notwithstanding engagement and advocacy short of a control contest. The current FTC conception of "solely for investment" is not clear, and appears overly expansive.

The differing SEC and FTC missions are of vital importance for our members. The SEC's mission includes protecting and ensuring fair treatment for investors and promoting strong, effective and efficient capital markets. As for the FTC: smart and effective policy to promote competition is crucial for the economy and therefore for long-term investors, certainly including pension funds that generally are invested across the economy. Clearly, there can be investor practices that compromise fair disclosure, inappropriately use material non-public information or that result in restraint of trade, and we support well-tailored SEC and FTC rules to patrol for these various potential abuses.

That said, both SEC and FTC rules must be based on careful analysis. And to the extent that existing or contemplated FTC rules interfere with investment processes, including on investor voting and engagement, the costs to investors and to effective corporate governance should be recognized and considered.

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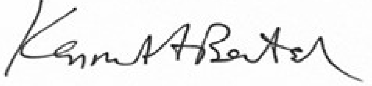
We would underline that vital interests of tens of millions of investors – such as pension fund and 401(k) plan beneficiaries, as well as individuals who put their savings directly into mutual funds and ETFs – potentially are at stake in the debate over common ownership. Indeed, American economic dynamism, based on structures of accountability of managements and boards to shareholders, could be damaged. We urge the FTC to take great care in weighing whether "common ownership" is in fact leading to anticompetitive behavior, not least so that the FTC concentrates its regulatory resources on real problems and not on antitrust distractions. Should at some point the FTC determine that there is some merit in the common ownership hypothesis, it is critical that the Commission pursue and recommend narrowly tailored policies that fully weigh costs of any policy change to the American system of corporate governance, and to pension fund beneficiaries and Mom and Pop individual investors.

Thank you for the opportunity comment and to participate in the December 6 hearing. We would be more than happy to discuss these issues further. Please contact Ken Bertsch or Jeff Mahoney at 202.822.0800 (ken@cii.org; jeff@cii.org).

Sincerely,



Kenneth A. Bertsch
Executive Director