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Antitrust and Institutional Investor Involvement in Corporate Governance - Note by Edward B. Rock and Daniel L. Rubinfeld

Hearing on Common Ownership by institutional investors and its impact on competition

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More documents related to this discussion can be found at
www.oecd.org/daf/competition/common-ownership-and-its-impact-on-competition.htm.

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Antitrust and Institutional Investor Involvement in Corporate Governance

Note by Edward B. Rock and Daniel L. Rubinfeld

1. For the past thirty years, regulatory reform efforts have focused on encouraging diversified institutional investor involvement in corporate governance. The goal has been to induce institutional investors to play a "stewardship" role in which they monitor the performance of management of portfolio companies and thereby overcome the "separation of ownership and control" that has challenged corporate governance since at least the 1930s. As the recent amendments to the EU's Shareholder Rights Directive observe:

> *Effective and sustainable shareholder engagement is one of the cornerstones of the corporate governance model of listed companies, which depends on checks and balances between the different organs and different stakeholders. Greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies . . .*
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> *Institutional investors and asset managers are often important shareholders of listed companies in the Union and can therefore play an important role in the corporate governance of those companies, but also more generally with regard to their strategy and long-term performance. However, the experience of the last years has shown that institutional investors and asset managers often do not engage with companies in which they hold shares and evidence shows that capital markets often exert pressure on companies to perform in the short term, which may jeopardise the long-term financial and non-financial performance of companies and may, among other negative consequences, lead to a suboptimal level of investments, for example in research and development, to the detriment of the long-term performance of both the companies and the investors.*[1]

2. Now, some recent economic research has suggested that the move should be in the *opposite* direction. In two recent papers Azar, Schmalz, and co-authors have argued that concentration among shareholdings by institutional investors has led to higher prices in two relatively concentrated industries: airlines and banking.[2] Based on this research, Einer Elhauge has claimed that current ownership patterns by diversified institutional investors violate Section 7 of the U.S. Clayton Act.[3] Finally, assuming that shareholder concentration is potentially a serious problem, several prominent scholars have offering a policy prescription. To be specific, Posner, Scott Morton and Weyl propose a "solution" in which diversified investors who wish to be at all active in corporate governance would

[1] 2017 Amendments to the Shareholder Rights Directive, ¶¶ 14-15.

[2] Jose Azar, Martin C. Schmalz, and Isabel Tecu, "Anti-Competitive Effects of Common Ownership, Journal of Finance, forthcoming, 2018 and Jose Azar, Sahil Raina, and Martin Schmalz, "Ultimate Ownership and Bank Competition," working paper, 2016.

[3] Einer Elhauge, "Horizontal Shareholding," 129 *Harvard L. Rev*. 1267 (2016).

be limited to acquiring one firm in any oligopolistic industry (or be capped at 1%).[4] This "solution" would force large index funds that wished to continue offering their existing products to their existing customers to commit to governance "passivity," i.e., to cease all engagement with portfolio companies. While to our knowledge not currently on the table, it is certainly possible that a similar claim might be made with respect to EU Merger Control Regulation 139 or similar civil law regulations in other OECD countries.[5] For this reason, we believe that the issues raised by these scholars should be taken seriously. At a minimum, the timing is right for scholars not only to critically examine the U.S.-centric issues, but to go a step further to review what we have learned and to consider what we have might learn with respect to similar issues outside the U.S.[6]

3. Given the important role played by institutional investors in corporate governance, we think that anyone who argues that institutional investors' current business models violate the antitrust laws or should otherwise be held to be illegal bears a heavy burden of persuasion. In this brief overview and extension of our forthcoming article, we offer our interpretation of the economic evidence, focusing on the airline industry.[7] We then summarize our challenge to Elhauge's legal analysis, and our concerns about the proposals of Posner et al. Although we are unconvinced by the provocative claims of this new literature, we agree that an open discussion of the antitrust implications of common ownership by large institutional investors is appropriate and timely. We meet this challenge by sketching out and defending proposed "Antitrust Guidelines," including a safe harbor, in an effort to prevent possible anticompetitive effects, while continuing to encourage institutional investor involvement in corporate governance.

4. The core claim of Azar, Schmalz et al is that the correlation between common ownership and airline fares are causal, that the concentration of shareholdings has *caused* airline fares to rise by as much as 10%. This arises, according to Azar et al, because managers of airlines, in choosing business strategies, take into account the effect of those strategies on the value of the stock portfolios held by their actual shareholders, rather than simply trying to maximize the value of their own airlines.

5. We find this assertion implausible theoretically and unconvincing empirically. The core problem is that the airlines' shareholders have very different portfolios – some own all the major airlines, others only some, and some only one. Even if one presumes that the managers of the airlines are aware of the holdings of their investors, we do not

4 Eric Posner, Fiona Scott Morton, and Glen Weyl, "A Proposal to Limit the Anti-Competitive Power of Institutional Investors," *Antitrust Law Journal*, forthcoming, 2018.

5 See, e.g., September 2017, Blank Rome report, "Germany Sides with Institutional Investors in Competition Debate," available at https://www.blankrome.com/index.cfm?contentID=37&itemID=4351

6 Serdar Celik and Mats Isaksson, "Institutional Investors and Ownership Engagement," *OECD Journal: Financial Market Trends*, Volume 2013/2 (2014) explains that there is a high degree of variability of ownership engagement within and across categories of institutional investors. Amiya K. Sahu, "Does Institutional Shareholding Affect Firm Value? An Empirical Analysis in Indian Market," Goa Institute of Management, June 9, 2015, finds that holdings of foreign financial institutions (FIIs) positively affect firm performance, with the conclusion that foreign firms are better monitors of fund performance than domestic firms. See also, OECD, "Corporate Governance: The Role of Institutional Investors in Promoting Good Corporate Governance," 2011.

7 Edward B. Rock and Daniel L. Rubinfeld, "Antitrust for Institutional Investors," *Antitrust Law Journal*, forthcoming, 2018.

see how this knowledge would affect the airlines' business strategies in a way that would affect overall industry pricing. One problem is that institutional holdings vary among the airlines and they tend to change over time. Another problem is that ownership at the level at issue here –below 15%– does not correlate with control. Other than maximizing the value of their own company, we do not see how any other strategy could command the approval of investors with heterogeneous and often changing portfolios.

6. The heterogeneity arises from the different approaches of different investors: although index funds will necessarily have similar holdings, actively managed mutual funds and other stock pickers compete vigorously on performance and will have very different holdings from each other and from index funds. Thus, in the airline industry, while firms that primarily manage index funds like Vanguard, BlackRock, and State Street might plausibly have an economic incentive to prefer "soft competition," an active manager like PRIMECAP that holds low-cost carriers such as Southwest and JetBlue will push to undercut Delta and United if that would be in the unilateral interest of Southwest and JetBlue, respectively. T. Rowe Price, with its airline investments concentrated in American Airlines, by contrast, would likely object were American's management to take into account the effect of its strategy on Delta and JetBlue. The fact that airline holdings have changed dramatically over time further complicates the analysis. Thus, as we discuss further in our paper, if one compares the top ten shareholdings in Southwest as of March 31, 2013 with the shareholdings in Southwest as of 2016Q4, we see that while PRIMECAP was the largest shareholder at both times, Berkshire Hathaway acquired its 7% sometime between the two periods. T. Rowe Price, by contrast, reduced its holding from 5.3% to 1.26% while Fidelity increased its holding from 3% to 5.53%.[8]

7. Confronted with the fundamentally heterogeneous, conflicting, and constantly changing preferences of actual shareholders (driven by heterogeneous and changing portfolios) with regard to whether and the extent to which the returns of other firms in the industry (and outside it) should count, the only strategy that will win support among the investors is to maximize the value of the single airline, without paying attention to the impact on the value of competitors. We don't see how airline managers can plausibly optimize profits against the portfolio preferences of investors because those preferences are too diverse. The heterogeneity problem is the basis for the core "separability" assumption in finance that assumes that firms maximize firm value irrespective of shareholders' myriad interests, an assumption explicitly challenged by Azar et al.

8. A further difficulty is distinguishing between the effects of common ownership and the possibility that individual airlines in the oligopolistic U.S. airline industry have simply learned how to price, individually concluding that it is in their own self-interest to move towards a tacitly collusive outcome by unilaterally raising fares on certain routes with the hope that others will follow, or by cutting capacity on certain routes, again with the hope that others will follow. It is well understand that such unilateral conduct does not

[8] Moreover, the data upon which these rankings of holdings are based – Form 13F filings and proxy statements – are problematic for several reasons. First, 13Fs are notoriously inaccurate. Second, they are incomplete insofar as they do not provide a comprehensive disclosure of "short" interest and derivatives. Third, they do not distinguish between the right to sell and the right to vote.

violate the U.S. Sherman Act, but the possibility that there has been some form of coordinating behavior with respect to capacity remains an open issue.[9]

9. Turning to the empirical analysis, we come to the issue with a view about the nature of competition in the airline industry. While, to our knowledge, individual airlines are highly competitive, there is substantial concentration among the four major U.S. carriers, American, Delta, United, and Southwest. The degree to which airlines these (and other) airlines have market power in individual airline markets (typically defined as individual origin-to-destination routes) varies substantially across markets, with the presence or lack of presence of low-cost or ultra-low-cost carriers on individual routes being one important driver of profitability.[10] We would not be surprised, therefore, to find a positive correlation between airline fares and concentration, as measured by the Herfindahl-Hirschman index, or HHI, on a route-by-route basis. Because of this, it is widely understood by industrial organization economists who study the airline industry that it is essential to account econometrically for the endogeneity of the HHI before one can draw any causal implications from an analysis of the relationship between fares and concentration.[11]

10. Although the Azar et al. paper tries to account for the potential endogeneity of the share concentration, they largely ignore the endogeneity of the underlying industry concentration.[12] This, we argue, is a serious limitation of their analysis and undermines the argument for a causal link between concentration of ownership and ticket prices. In addition, while the paper does account to some extent for the effect of the presence of low cost carriers (by including a Southwest Airlines dummy and a dummy reflecting the presence of another low-cost carrier), the specification is not likely to account fully for between-market variation in airline market power. It remains to be seen whether the authors' results are driven largely by markets in which the major airlines have substantial market power.[13]

11. Furthermore, when we look more deeply into the claimed channel of influence – executive compensation – we are likewise unconvinced. Azar et al rely on a related paper that views the channel of influence to be the (relative) absence of "Relative Performance

[9] *In Re: Domestic Airline Travel Litigation*, U.S. District Court for the District of Columbia, Case: 1: 15-mc-01404. To our knowledge, the claims in this case do not involve the holdings of institutional investors.

[10] Individual markets often include multiple (but not necessarily all) airports in major U.S. cities.

[11] Like many studies of airline pricing, the Azar et al study involves the estimation of a "reduced form" equation, one that includes both supply-side and demand-side variables that would be included in a "structural model" of the airline industry. See, for example, Jan Brueckner, Darin Lee, and Ethan Singer, "City Pairs Versus Airport-Pairs: A Market-Definition Methodology for the Airline Industry," *Review of Industrial Organization*, Vol. 4, Issue 1 (2014), pp. 1-25.

[12] The authors' instrument, reflecting Blackrock's acquisition of Barclays Global Investors, would be more compelling if there were a compelling theory that explaining why the channel by which the increased ownership would be translated into higher airline fares.

[13] A recent paper by Patrick Dennis, Kristopher Gerardi, and Carola Schenone ("Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry," draft November 1, 2017) supports our view. The authors find no relationship between institutional ownership and airline fares when (among other things) they (i) do not weight by passenger counts; and (ii) they employ a widely-utilized instrument to account for the endogeneity of the HHI.

Evaluation" ("RPE") in management compensation in concentrated industries.[14] The idea is that without RPE, managers will care more about the profits of other firms in the same industry. Examining airlines, we find that contrary to the Azar et al assumption, RPE is pervasive in the airline industry, as one would expect given the pressure from leading shareholders and Institutional Shareholder Services ("ISS") to utilize relative performance measures in structuring compensation.

12. Our view of the relationship, if any, of institutional investor holdings and oligopolistic competitor pricing is admittedly driven primarily by our analysis of the U.S. airline industry. Subject to that qualification, we find that there is, as yet, no compelling causal link between the concentration of institutional investor holdings and industry pricing. It is theoretically possible, of course, that even if there is no such link, that industry pricing would be different if the industry were not oligopolistic. While one might have a reasonable debate about the merits of the consolidating mergers in the airline industry, we note that there are, to our knowledge, no antitrust statutes that posit concentration per se to be an antitrust violation.

13. Turning to the U.S. legal environment and Prof. Elhauge's arguments, we undertake a comprehensive analysis of the legal framework, starting with Clayton Act Section 7 and the seminal 1957 Supreme Court case, *U.S. v. DuPont (GM).* The key legal issues are (a) whether there is evidence that the holdings are anti-competitive and (b) the scope of the "solely for investment" exemption. Contrary to the analysis of Elhauge, we conclude that existing ownership patterns do not violate Section 7, a position that is consistent with decades of DOJ/FTC enforcement policy.[15]

14. Finally, with regard to the policy proposals of Posner et al., we believe it too early to put on the table aggressive policy proposals that would force index funds to change their highly successful business model and limit themselves either to buying one firm in any concentrated industry or to complete governance passivity ("putting the shares in a drawer"). Faced with this dilemma, we have no doubt that index funds would opt for complete passivity rather than abandoning indexing, as the easiest and surest way of availing themselves of the "solely for investment" exemption, while preserving their core business model. Because the cost to corporate governance of this predictable behavior would be high, we believe that any theory of antitrust liability that would induce this conduct should be viewed skeptically.

15. To be clear, we take seriously the core issue raised by this provocative line of research raises, namely, the intersection between the increased concentration of shareholdings and antitrust. If a single investor were to acquire controlling positions in competing airlines, the acquisition could well violate Section 7 of the Clayton Act. Likewise, if a portfolio manager were to organize the airlines into a cartel, that would clearly violate Section 1 of the Sherman Act. But we are unconvinced by the claims that the existing patterns of non-controlling common ownership positions are anticompetitive. Because we – and current U.S. law – view "control" (or substantial influence that approaches control) as the critical factor, we have sketched out and defended proposed

[14] Miguel Anton, Florian Ederler, Mireai Gine, and Martin C. Schmalz, "Competition, Ownership, and Top Management Incentives, CESifo Working Paper. No. 6178, Dec. 2016.

[15] For a view that the Clayton Act can have relevance with respect to the holdings of institutional investors, see Fiona M. Scott Morton and Herbert J. Hovenkamp, "Horizontal Shareholding and Antitrust Policy," University of Pennsylvania, Institute for Law and Economics, Research Paper 17-41, October, 2017.

"Antitrust Guidelines," including a presumptive safe harbor for investments below 15%, with no board representation and only "normal" corporate governance activities.[16]

16. The key takeaway is clear: although the current structure of institutional investor ownership does not violate the antitrust laws, institutional investors, like industrial companies, must be conscious of antitrust risk and should train their professionals accordingly.

[16] We say presumptive because we can imagine circumstances in which the presumption could be overcome: consider, e.g., two firms in a duopoly each with the same ten shareholders that each hold 10% of the shares of each firm. This hypo was proposed by Steve Salop. Panel discussion, Unlocking the Promise of Antitrust Enforcement, October 27, 2017 available at https://www.wcl.american.edu/news-events/events/detail/5593/ (afternoon panel).