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Asset Managers are Focus of FTC Hearing on "Common Ownership" Investments

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The Federal Trade Commission ("FTC" or the "Commission") convened a hearing on December 6, 2018 to better understand the possible anticompetitive implications of institutional investors holding non-controlling amounts of voting securities in competing firms. The hearing, entitled "Corporate Governance, Institutional Investors, and Common Ownership," was presided over by FTC Commissioners Noah Joshua Phillips and Rohit Chopra and featured remarks by Securities and Exchange Commission ("SEC") Commissioner Robert J. Jackson, Jr.

Although the Commission did not define the term "institutional investor," it was clear from the testimony of industry insiders, academics and government officials that the inquiry was focused on large, passive index funds, led by the "Big Three," BlackRock, Vanguard and State Street. Private equity and hedge fund investments in competing firms were barely mentioned and, in response to a direct question put to a panel of academics, dismissed as an issue.

Setting the Table. The hearing explored two possible theories of competitive harm. First, do passive index funds that invest across an industry structurally disincentivize target firms from competing? Second, do such investments foster anticompetitive collusion?

Two Ships Passing in the Night. The hearing featured two principal panels and several highlighted presentations. The morning panel was composed of industry insiders, including a member of the Big Three, a large union pension fund, several investor/industry trade associations and several corporate governance experts. The afternoon panel featured several notable antitrust economists and law professors. (A late afternoon panel of economists discussed and critiqued the empirical bases for the passive structural theory of harm.)

The order of the first two panels may have contributed to what appeared to be a disconnect between them. Unfortunately, it was not until the afternoon panel that the hearing framed, and explained the theoretical groundwork for understanding, the central issue of the day: whether index funds impede competition by their very structure. The lack of focus may have misled the morning panel to devote itself largely to defending the industry against the more easily understood issue of

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possible collusion between institutional investors and members of a given industry. The panel convincingly described antitrust and securities guardrails in place at every institutional investor and every public company. Indeed, collusion in this context is *not* a well-documented threat, and the panel treated proposals to limit possible harm as solutions in search of a problem. Despite its emphasis on the lack of collusion between funds and industry competitors, however, the industry panel made several overarching points that hit home and hovered as a blinking caution light over the rest of the hearing, including the facts that index funds have become a key driving force for our nation's savers of households, retirees, workers and investors, and that prohibiting institutional investors from investing in a diversified portfolio within industries would be a death knell to such funds.

For their part, the expert panel of economic and law professors argued that investors who hold a significant percentage of securities in large firms in concentrated industries may be unlikely to push management in those firms to be more competitive, cutting costs and prices, because the funds' most rational strategy for maximizing profits would be for each industry member to charge prices as high as the markets will bear, leading to each firm's maximum profitability. Under this theory, management would understand and be responsive to its large investor incentives. The theory, however, rests largely on one seminal paper that drew its analysis from a theory that was adapted in a different context. Until this year, there has been very little additional scholarship to test the theory empirically.

Where Do We Go from Here? Speakers largely agreed that more study should be undertaken before any agency attempts to fashion new regulations. (FTC regulation to combat consumer harm likely would focus on *conduct* and could limit investments in competing firms; SEC regulation to combat investor harm likely would focus on fund disclosures.) Government officials recognize that they do not yet understand whether passive index funds by their nature reduce competition across invested industries. The economic studies generating the concerns are controversial even among economists and far too few to produce academic consensus. Significantly, most of the economists indicated that more focused research may require the ability to issue compulsory process, a power that academics lack but that law enforcement agencies possess.

Good News, Bad News. The good news for the asset management industry is the apparent consensus that more investigation is needed before either the FTC or SEC adopts a theory of harm and fashions a remedy to address it; the bad news for the asset management industry is the current lack of clarity may lead to full-blown FTC and SEC investigations into asset management. Specifically, multiple hearing witnesses encouraged the FTC to use compulsory process (subpoena power) to obtain data from the asset managers and the industries they invest in and to subpoena target management documents in an effort to determine whether management strategy decisions are being based, at least in part, on an understanding of its investors' relative interests.

Practice Tip: Asset managers may want to get ahead of the curve by understanding what their strategy documents say about their expectations of management incentives. Asset managers, or an industry trade association, may want to begin developing their own "white papers" to forestall further government concerns. By contrast, activist funds should take appropriate steps to implement antitrust compliance programs to avoid facilitating collusion between or among competing firms in which they are invested.

How Can Cadwalader Help?

Cadwalader's antitrust team is one of only a few to focus on the financial services sector. Located in key jurisdictions in the United States (New York, Washington, DC, Charlotte) and Europe (London, Brussels), we are specialists in offering 'end-to-end' advice on compliance, investigations and related litigation in this sector. Our practitioners are experienced in implementing effective antitrust compliance programs and conducting trainings on regulatory requirements.

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If you would like to discuss the issues arising in this alert, or how we can help you more generally, please contact:

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