COMPETITION AND COMMON OWNERSHIP – A GOVERNANCE PERSPECTIVE

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I. INTRODUCTION

Interest in the potential anticompetitive effects of "common ownership" – defined as stock ownership in competing companies by an investor holding less than control amounts – has emerged from recent studies that suggest a correlation between common ownership and higher prices in certain concentrated industries.[2] The empirical evidence is under development and debate,[3] yet proposals have already been made to restrict the ownership stakes of institutional investors.[4] Antitrust policy development in this area should be approached with great care given the relatively early stage development of the evidence, the ongoing debate about whether the evidence of an anticompetitive effect is sufficiently durable and robust, and the potential implications a restrictive investment rule would have on institutional investors' beneficial roles in satisfying consumer interests in diversified investment vehicles for retirement and college savings, and in promoting improved corporate governance practices. This article discusses corporate governance issues related to the common ownership debate and observes as follows:

- First, while institutional investor influence on publicly traded corporations has increased considerably in the past twenty years, the subjects of this influence – as evidenced by the topics on which they vote and engage – do not typically include ordinary course business decisions such as the prices to charge, or the products to offer.

- Second, both institutional investors and the proxy advisors who make recommendations on how these investors should exercise their advisory vote on executive compensation heavily emphasize – as reflected in their proxy voting policies – that executive compensation should be aligned with company performance relative to their peers (including competitors) and not with industry-wide performance. In other words, institutional investors expressly pressure boards of directors to link management's incentive compensation to success in outperforming competitors.

2 Jose Azar, Martin C. Schmalz & Isabel Tecu, "Anticompetitive Effects of Common Ownership," 73 J. of Fin. 1513 (August 2018) (airlines); Jose Azar, Sahil Raina & Martin C. Schmalz, "Ultimate Ownership and Bank Competition," (Jul. 23, 2016) (commercial banking), available at http://ssrn.com/abstract+2710252. For a review of this literature see Martin C. Schmalz, "Common Ownership, Concentration and Corporate Conduct," SSRN Scholarly Paper ID 3165340 (Soc. Sci. Res. Network), Feb. 26, 2018.

3 Edward B. Rock & Daniel L. Rubinfeld, "Antitrust for Institutional Investors," 82 Antitrust L. J. 221 (2018); C. Scott Hemphill & Marcel Kahan, "The Strategies of Anticompetitive Common Ownership," at 6 (August 1, 2018; last revised December 17, 2018), NYU Law and Economics Research Paper No. 18-29; European Corporate Governance Institute (ECGI) - Law Working Paper No. 423/2018, available at https://ssrn.com/abstract=3210373.

4 Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, "A Proposal to Limit the Anticompetitive Power of Institutional Investors," 81 Antitrust L. J. 669, at 724 (2017); Edward B. Rock & Daniel L. Rubinfeld, "Antitrust for Institutional Investors," 82 Antitrust L. J. 221 (2018).

- Third, the topics on which corporations and their institutional investors engage is heavily influenced by legal concerns, including the need to strictly comply with federal securities and antitrust laws and regulations. In preparation for engagement with investors, corporate directors and managers are advised by legal counsel. Focused attention by counsel in line with written Securities and Exchange Commission ("SEC") and other guidance on engagement activity undermines the notion that engagement is a means through which investors encourage companies to soften their competition or through which companies communicate confidential information about their competitive plans.

- Fourth, institutional investor engagement with portfolio companies has contributed to decisions by corporate boards to improve corporate governance practices, and to provide greater transparency into board decision-making.

From a corporate governance perspective, the hypothesis of broad anticompetitive collusion linked to common ownership does not fit with how institutional investors and companies engage with one another. (As noted by the United States in its submission to the OECD, regulators already have sufficient tools to address intentional anticompetitive conduct should evidence of specific instances of such conduct arise.[5]) Restricting institutional investor investment and related governance engagement would have broad implications outside the antitrust policy sphere.

II. SHAREHOLDER INFLUENCE DOES NOT EXTEND TO ORDINARY BUSINESS MATTERS

While institutional investor influence on publicly traded corporations has increased considerably in the past twenty years, the subjects of this influence – as evidenced by the topics on which they vote and engage – do not typically extend to ordinary course business decisions by portfolio companies such as the prices to charge or the products to offer.

Under state law, shareholder decision rights are generally limited to a short list of fundamental matters that transcend the direction and management of the business (which is the responsibility of the board of directors, not the shareholders), such as electing directors, amending the certificate of incorporation and the bylaws, and approving significant corporate transactions such as mergers, consolidations, or the sale of substantially all of the assets. In addition, shareholders of New York Stock Exchange and Nasdaq listed companies must approve equity compensation plans and certain share issuances. Outside of their limited decision rights, shareholders cannot dictate the actions of the corporation's board or officers who, as fiduciaries, are required to make their own judgments in "managing the business and affairs of the corporation." Instead, shareholder influence comes in large measure from their ability under federal law and regulation to bring non-binding shareholder proposals in company proxy materials,[6] and also to have an advisory vote on executive compensation and on "golden parachute" compensation.[7] Publicly traded companies face significant pressure to address compensation issues when the shareholder vote does not significantly support the board's approach to executive compensation issues, and also to implement majority-supported shareholder proposals, even though the shareholder vote is non-binding. Failure to be responsive to shareholder votes can lead the proxy advisory firms who advise institutional investors to recommend voting against the re-election of directors.[8]

Under SEC regulations, ordinary business operations are not a proper subject of shareholder proposals.[9] Absent a sufficiently significant policy issue, matters of ordinary business, such as what products to offer, what prices to charge, and what areas to compete in, are excluded from shareholder proposals.

The framework for shareholder efforts to influence corporate behavior is in the delineation of shareholder rights and board responsibilities under state law and the additional federal overlay of areas that are appropriate for shareholder proposals to be included in the company's proxy materials. As reflected in their own stated engagement priorities, large institutional investors focus their efforts to influence portfolio companies not on ordinary business operations, but on shareholder rights, board accountability and attention to strategy, governance processes, the struc-

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5 Note submitted by the United States to the OECD for December 6, 2017 OECD Hearing on Common Ownership by Institutional Investors and Its Impact on Competition, (Nov. 28, 2017) at 3.

6 Securities Exchange Act of 1934, as amended ("Exchange Act") Rule 14a-8 and SEC Division of Corporation Finance Staff Legal Bulletins 14 & 14A - 14J.

7 See Exchange Act Rule 14a-21.

8 Institutional Shareholder Services ("ISS"), United States Proxy Voting Guidelines (Dec. 2018) at 13, 40 and 42-43; Glass Lewis, 2019 Proxy Paper Guidelines, United States (Oct. 2018) at 10, 14, 16 and 34.

9 Exchange Act Rule 14a-8(i)(7); SEC Division of Corporation Finance Staff Legal Bulletin No. 14I (CF) (Nov. 1, 2017).

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ture of executive incentive compensation, and company disclosure of policies regarding corporate social and environmental responsibility. For example, BlackRock's Investment Stewardship Engagement Priorities for 2019 include: (1) Governance including board composition, effectiveness, diversity, and accountability; (2) Corporate strategy and capital allocation that provide a clear sense of the direction a company intends to take; (3) Executive pay policies that link closely to long-term strategy, goals and performance; (4) Disclosure of environmental risks and opportunities to enhance understanding of board and management oversight of policies, risk factors and opportunities that drive long-term financial performance; and (5) Human capital management including sound business practices that create an engaged and stable workforce.

According to stewardship reports from large institutional investors and surveys of corporate directors and members of management, the most common topics for engagement in 2018 and 2017 were:

- Board composition, quality and accountability, including the alignment of board composition and strategy, director tenure and diversity, independent board leadership and board oversight of risk and strategy;
- Climate related risk reporting and board oversight re sustainability;
- Executive compensation including alignment of compensation with company performance;
- Shareholder rights including annual election of directors, supermajority vote requirements, special meeting and written consent thresholds, and proxy access;
- Gender pay parity; and
- Risks associated with opioids and weapons.[10]

III. INSTITUTIONAL INVESTORS SEEK COMPANY-SPECIFIC ALIGNMENT OF PAY AND PERFORMANCE

The express voting policies of both institutional investors and their proxy advisors heavily emphasize that executive compensation should be aligned with company performance relative to their peers (including competitors) and not with industry-wide performance. These express policies are directly at odds with the hypothesis that corporations in concentrated industries with common ownership by large institutional investors understand that these investors want them not to compete, and prefer that compensation is aligned with industry rather than company performance.

The proxy voting policies of the largest institutional investors provide in clear and direct terms that misalignment between pay and company performance is grounds for a negative "say-on-pay" vote and in certain circumstances grounds for a negative vote on the re-election of compensation committee members.[11] Similarly, proxy advisors ISS and Glass Lewis both incorporate relative performance evaluation into their analysis and will issue negative recommendations for the shareholder advisory vote on executive compensation if executive pay and company performance are not aligned.[12] Misalignment of pay and company performance relative to peers is the most common reason for proxy advisors to recommend a negative vote on compensation and for a company to fail to achieve high levels of shareholder support on the advisory vote on executive compensation.[13]

Boards and their compensation committees pay close attention to investor and proxy advisor policies on compensation, the vote recommendations of the proxy advisors, and the outcome of the votes. If the shareholder advisory vote on executive compensation fails, or passes but

10 BlackRock, Investment Stewardship 2018 Annual Report (Aug. 2018); State Street, Stewardship 2017 (July 2018); State Street, Stewardship Activity Reports Q1 & Q2 2018; Vanguard, Investment Stewardship Annual Report 2018 (Aug. 2018); Vanguard, Engaging with Vanguard (2018).

11 BlackRock, Proxy Voting Guidelines for U.S. Securities (Feb. 2018) at Appendix; BlackRock, BlackRock Investment Stewardship's Approach to Executive Compensation (Mar. 2018); State Street, Global Proxy Voting and Engagement Principles (Mar. 2018); State Street, Proxy Voting and Engagement Guidelines – North America (Mar. 2018); Vanguard, Policies and Guidelines (last accessed Apr. 14, 2019).

12 ISS, United States Proxy Voting Guidelines (Dec. 2018) at 40. ISS, Pay-for-Performance Mechanics (Dec. 2017); Glass Lewis, 2019 Proxy Paper Guidelines, United States (Oct. 2018) at 32, 34 and 36.

13 ISS, U.S. Compensation 2018 Proxy Season Review (Aug. 27, 2018) at 5. See also Semler Brossy, 2018 Say on Pay Results (Oct. 4, 2018) at 8.

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without a high level of majority support (70 percent or more), it is common practice among S&P 500 companies to engage with investors to find out what drove the vote results and to adjust compensation structure and metrics in response.[14]

IV. SHAREHOLDER ENGAGEMENT IS SUBJECT TO STRICT LEGAL LIMITS AND LEGAL SCRUTINY

Since the advent of the mandated shareholder vote on executive compensation ("say-on-pay") in 2011, engagement efforts between shareholders and corporations have increased exponentially. Engagement has proven to be an effective tool for releasing tensions between shareholders and corporations, improving boards' understanding of shareholder concerns, and improving shareholders' understanding of how boards of portfolio companies approach their oversight of long-term strategy and other responsibilities. Corporate engagement efforts may be motivated by an interest in convincing shareholders to provide support for management on say-on-pay or on a shareholder activism issue, but increasingly corporations undertake engagement efforts on a regular basis to help strengthen relations with key shareholders and to foster a better understanding of how shareholders view the company. Similarly, large institutional shareholders may seek engagement with portfolio companies to explain their point of view on a corporate governance matter, or to learn more about the drivers of corporate decisions. For example, Vanguard states that its aim in engagement is to build a strong understanding of how companies govern their long-term strategy, not to seek to influence company strategy.

The topics on which corporations and their institutional investors engage are heavily influenced by legal concerns, including the need to strictly comply with federal securities and antitrust laws and regulations. It is common practice for legal counsel to provide corporate directors and members of the management team with strict instructions about the rules of engagement and the parameters of topics for engagement.[15] In line with SEC Staff Guidance and other guidance on engagement practices, discussion topics are typically pre-cleared with the shareholder, and company counsel either participates in the meeting or briefs the company's participants in advance.[16] Thus, focused attention by counsel in line with written guidance on engagement activity undermines the notion that engagement is a means through which investors encourage companies to soften their competition, or through which companies communicate confidential information about their competitive plans: Specifically, through engagement policies and direct instruction from counsel, participants are reminded that they must not selectively disclose material non-public information in violation of Regulation FD. They are reminded about tipping and insider trading liability that could result from someone misusing material non-public information, and if engagement is occurring during proxy season, special care is given to abide by the proxy solicitation rules which only permit attempts to influence shareholder votes based on what has been disclosed in filed proxy soliciting material. Directors and officers are also reminded not to discuss competitive information, customer-specific information or details about the company's pricing, production capacity or market share.

Participation by independent directors is becoming more common in meetings with institutional investors. For example, if executive compensation is to be a topic of discussion, the compensation committee chair often participates, and engagement efforts are often reported to the board or an appropriate board committee. Hence, while engagement between institutional investors and directors and management members reflect a range of styles, common guardrails have emerged as a result of SEC guidance, the counsel of legal advisors and the emergence of "best practice" guidance such as the SDX Protocol which identifies common engagement topics and procedures.

Given the legal concerns that need to be navigated in engagements between corporations and their shareholders, and the involvement of counsel in preparing for these efforts – and at times participation by independent directors – engagement efforts are under considerable scrutiny and are unlikely to provide opportunity for investors to influence boards and managers to ease up on competition.

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14 Radford Aon, Lessons from the 2018 Proxy Season for Say-on-Pay and Equity Plan Votes (July 2018). See also Exequity, Bouncing Back from a Low Say-on-Pay Vote (Aug. 28, 2018); Semler Brossy, Handling Say-on-Pay Aftershocks: How Directors Can Prepare for Elections After a Poor Vote Outcome (Aug. 17, 2015).

15 See Sidley Austin LLP, Outline of Key Legal Considerations in Shareholder-Company Engagement (Feb. 2016), Investment Company Institute 2016 Mutual Funds and Investment Management Conference (Orlando, FL, Mar. 13-16, 2016), Supplemental Materials for Session 2-D, available at https://www.ici.org/pdf/16_mfimc_ebinder.pdf (last accessed Apr. 14, 2019) (hereinafter "Sidley Outline of Key Legal Considerations in Shareholder-Company Engagement"); NACD, Governance Challenges 2018: Board-Shareholder Engagement in the New Investor Environment (2018) (hereinafter, "NACD Governance Challenges 2018"); The Conference Board, Guidelines for Investor Engagement (Mar. 2014); The Shareholder-Director Exchange, Introduction and Protocol (Feb. 2014).

16 SEC Staff Compliance & Disclosure Interpretations, Regulation FD, Question 101.11 (June 4, 2010); NACD Governance Challenges 2018; The Conference Board, Guidelines for Investor Engagement (Mar. 2014); The Shareholder-Director Exchange, Introduction and Protocol (Feb. 2014).

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V. INSTITUTIONAL STEWARDSHIP BENEFITS CORPORATE GOVERNANCE

While the stewardship impact of large institutional investors on the accountability of corporate boards and managers may not yet be sufficient in the views of some observers,[17] institutional investors have become far more engaged in efforts to influence corporate governance over the past decade. The engagement with portfolio companies has contributed to decisions by corporate boards to improve corporate governance practices, and to provide greater transparency into board decision-making. For example, in response to a combination of engagement and non-binding shareholder proposals, a majority of S&P 500 boards now require annual election of all directors ("declassified" boards), majority voting in the election of directors (replacing plurality voting standards in uncontested elections), and shareholder access to the company's proxy to nominate directors.

This investor influence has a multiplier effect: Other corporate boards take heed of these developments as evidence of evolving best practices and broad shareholder expectations, making it more likely that corporate boards will implement these kinds of changes without the same level of direct shareholder engagement (and thereby reducing the risk of likelihood of any engagement effort that may soften competition), and in many instances voluntarily.

VI. CONCLUSION

If a decline in competition in concentrated industries occurs where there is also common ownership, the type of engagement between institutional investors and portfolio companies that has arisen largely in the last decade (in the wake of the Dodd-Frank Wall Street Reform and Consumer Protection Act) is an unlikely mechanism through which investors and portfolio companies might plan anti-competitive actions. Antitrust regulators already have ample tools to address intentional anticompetitive behavior should they find instances of illegal activity.

To the extent that even absent intentional anticompetitive conduct, anticompetitive effects arise where there is common ownership (evidence of which is neither fully developed nor agreed upon),[18] policy makers will face difficult tradeoffs given the benefits that institutional investors provide by satisfying consumer interests in diversified investment vehicles for retirement and college savings, and by engaging on corporate governance matters with portfolio companies.

17 See Lucian Bebchuk & Scott Hirst, "Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy," (Working Draft June 2018; last revised, November 2018) and papers cited therein at note 13 and accompanying text.

18 Einer Elhauge, "Horizontal Shareholding," 129 Harv. L. Rev. 1267, at 1270 (2016). But see, e.g. C. Scott Hemphill & Marcel Kahan, "The Strategies of Anticompetitive Common Ownership," at 6 (August 1, 2018; last revised December 17, 2018), NYU Law and Economics Research Paper No. 18-29; European Corporate Governance Institute (ECGI) - Law Working Paper No. 423/2018, available at https://ssrn.com/abstract=3210373.

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