



# House of Representatives Inquiry into the Implications of Common Ownership and Capital Concentration in Australia

FSC Submission

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## 1. About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advice licensees and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing \$3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

## 2. Introduction

The Financial Services Council (FSC) welcomes the opportunity to contribute to the House of Representatives Standing Committee on Economics inquiry into the implications of common ownership and capital concentration in Australia.

We are aware that this is a debated issue overseas, particularly in the United States. We accept that this is a legitimate potential issue for policy makers to explore. There has been some recent debate about this issue in Australia as well (considered further below).

Maintaining a competitive economy is important for the long-term prosperity of Australians, and any trends in market concentration that have the effect of lessening competition, raising prices and limiting output in important industries to the detriment of consumer and economic outcomes demand special attention. In the Australian context, a paper published by Leigh and Triggs (2021)<sup>1</sup> identified 49 industries that have common ownership out of 443 industries examined, representing 35% of total industry revenues in Australia. These industries include health insurance, supermarkets and 14 grocery stores, fuel retailing, plumbing goods wholesaling, fertiliser manufacturing and copper ore mining.

However, the supposed negative anticompetitive effects for consumers resulting from common ownership have not been proven in Australia or overseas jurisdictions. There is a risk that policies may be considered that include heavy market intervention in the ordinary rights of shareholders based on contestable and tenuous conclusions reached in some academic literature. In the Australian context, common owners are sometimes identified as holding interests in competitor companies of a very small minority<sup>2</sup>, meaning that there remains a substantial diversity of ownership.

While it may be legitimate for further study to be undertaken to understand the extent of the phenomenon of common ownership in Australia, we note that this has been considered overseas and no clear causal link has been found between common ownership at current levels and substantial negative anticompetitive effects for consumers. Common ownership theories do not correspond to the actual practice of asset management and stewardship. They do not consider the strong incentives toward competition that exist, including remuneration and compliance with competition law. Law reform should not be undertaken to address a mischief that has not clearly been established.

Common ownership occurs because of the need for funds to diversify in order to minimise risk and maximise returns for investors, which is fundamental to their duty to act in the best interest of their members. If law reform measures that have been proposed overseas to combat the purported effects of common ownership were to be adopted, it could be to the detriment of the best financial interests of everyday Australians saving for their goals and retirement.

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<sup>1</sup> Andrew Leigh and Adam Triggs, 'Common Ownership of Competing Firms: Evidence from Australia' (Discussion Paper No 14287, Institute of Labor Economics, April 2021).

<sup>2</sup> see Andrew Leigh and Adam Triggs, 'Common Ownership of Competing Firms: Evidence from Australia' (Discussion Paper No 14287, Institute of Labor Economics, April 2021), 6.

In the context of our system of compulsory superannuation, the Committee should be mindful that proposed law reform measures overseas (which, it should be noted, have not been adopted) could well lead to a lessening of competition in the funds management and superannuation sector, and poorer financial returns for Australians.

### 3. Common Ownership: is there a problem?

Some academics have argued that common shareholding of competitors creates anticompetitive harms.<sup>3</sup> Empirical studies, such as the key study on airlines by Azar et al (2018)<sup>4</sup>, have purported to show that where there is common ownership in industries, there is a correlation with higher prices and lower output. Azar et al have suggested common ownership has raised prices by as much as 10%. However, the empirical analysis and conclusions are highly contested in academic literature.<sup>5</sup> For instance, Gramlich and Grundl (2017), in response to Azar et al (2016) state:

*'We see some results that are consistent with the anti-competitive effect that Azar, Schmalz, and Tecu find, but the sign of the effect is not robust, and implied magnitudes of the effects that are found are small.'*<sup>6</sup>

Importantly, these studies, while suggesting correlation, have not shown any clear causal mechanism.<sup>7</sup> Studies such as Denis et al (2019) show that the correlation could be accounted for by factors like market share rather than ownership and control.<sup>8</sup> Indeed, in a recent paper by Azar & Vives (2021)<sup>9</sup>, it was found that common ownership by 'inter-industry common owners' actually *reduces* consumer prices in the airline industry, counter-balancing any anti-competitive effect of 'intra-industry' common owners. This is significant because it counters the original hypothesis of Azar by suggesting that common ownership by institutional investors actually has a *pro-competitive* effect, which helps dampen potential anticompetitive effects by control-seeking investors such as private investors and hedge funds.

In this section, we will explore the different causal mechanisms that have been suggested that lead common ownership to create anticompetitive outcomes. We conclude that each of these proposed causal mechanisms have not been adequately proven.

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<sup>3</sup> As a key example, see Einer Elhauge, 'How Horizontal Shareholding Harms Our Economy – And Why Antitrust Law Can Fix It' (2020) 10(2) *Harvard Business Law Review* 207.

<sup>4</sup> Jose Azar, Martin C Schmalz and Isabel Tecu, 'Anti-Competitive Effects of Common Ownership' (2018) 73(4) *The Journal of Finance* 1513.

<sup>5</sup> See for instance C Scott Hemphill and Marcel Kahan, 'The Strategies of Anticompetitive Common Ownership' (2020) 129 *The Yale Law Journal* 1449; Pauline Kennedy, Daniel P. O'Brien, Minjae Song and Keith Waehrer, 'The Competitive Effects of Common Ownership: Economic Foundations and Empirical Evidence' (Research Paper, July 2017); Daniel P O'Brien and Keith Waehrer, 'The Competitive Effects of Common Ownership: We Know Less Than We Think' (Research Paper, February 2017).

<sup>6</sup> Jacob Gramlich and Serafin Grundl, 'Testing for Competitive Effects of Common Ownership' (Finance and Economics Discussion Series 2017-029. Washington: Board of Governors of the Federal Reserve System, February 2017).

<sup>7</sup> C Scott Hemphill and Marcel Kahan, 'The Strategies of Anticompetitive Common Ownership' (2020) 129 *The Yale Law Journal* 1449, 1447.

<sup>8</sup> Patrick Dennis, Kristopher Gerardi, Carola Schenone, 'Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry' (Working Paper 2019-15, Federal Reserve Bank of Atlanta Working Paper Series, July 2019).

<sup>9</sup> Joze Azar and Xavier Vives, 'Revisiting the Anticompetitive Effects of Common Ownership' (Research Paper, March 2021).

### 3.1. Incentives for corporate managers to lessen competition

It is argued that the causal mechanism for anti-competitive harms is that corporate managers in firms that have a common owner with competitors in the same industry have incentive to engage in less competitive behaviour in order to maximise the total value of the common owner's portfolio. They may be incentivised to do this due to wanting shareholder support at elections and for resolutions, and because of compensation methods. Reduced competition leads to higher prices (noting that according to this literature, this does not require coordination or communication between the firms as incentives are enough). It is argued this particularly occurs where diversified passive investors (investors who are not seeking control) do not insist on implementing expansion strategies. In short, the suggestion is that common ownership provides company managers with incentive to undertake a less competitive strategy, because this would be in the interest of their shareholders.

We submit that this causal mechanism is highly implausible for several reasons. Firstly, these conclusions assume that company managers would be taking into account the fact that they have common shareholders with competitors in their day-to-day actions executing the company's strategy. Without more evidence, this assumption is unconvincing. Hill (2020) calls this 'the mindreading model', which assumes that managers who are merely aware common ownership exists act on the presumed anticompetitive preferences of common owners.<sup>10</sup>

In the Australian context, the recent analysis done by Leigh and Triggs (2021) shows stakes by common owners in major concentrated industries amount to 5%-6% at most,<sup>11</sup> meaning that there is diversity in the ownership.<sup>12</sup> Out of the many owners, some with bigger stakes than the common owners, is it likely that company managers would be particularly concerned about the wider portfolio interests of common owners? Unless they are explicitly intending to contravene the law, given their legal obligations and high penalties for misconduct, it is difficult to see why company directors could be convinced to engage in business strategies that are not solely in the interest of their company. It would be strange if directors of individual companies, in violation of their fiduciary duty to the company, decided to sacrifice their individual company's profits and their own personal remuneration (discussed in more detail below) from their company stock for the vague interests of a minority group of shareholders.

It might also be argued that even if common owners such as asset managers do not directly encourage managers to engage in less competitive conduct, the very fact of common ownership means that asset managers can just abstain from actively encouraging firms they

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<sup>10</sup> Jennifer Hill, 'The Conundrum of Common Ownership' (Research Paper No 3546886, Monash University Faculty of Law Legal Studies Research Paper, March 2020), 14.

<sup>11</sup> Andrew Leigh and Adam Triggs, 'Common Ownership of Competing Firms: Evidence from Australia' (Discussion Paper No 14287, Institute of Labor Economics, April 2021), 6.

<sup>12</sup> See also Edward B Rock and Daniel L Rubinfeld, 'Antitrust for Institutional Investors' (Research Paper No 17-23, NYU Law and Economics Research Paper, July 2017), 14.

have common ownership in to compete.<sup>13</sup> Hill (2020) calls this the ‘lazy investor’ explanation.<sup>14</sup> It is argued this is enough to generate sub-optimal outcomes. However, it is not true that management would lack incentive to compete without the pressure of minority shareholders. Managers have strong incentives to maximise the profits of their own firm such as financial incentives like bonuses and equity, and industry reputation that will help with future job prospects.

While it may be theoretically possible that a common owner would prefer less aggressive competition, as noted before they are not the only owners of the company, or even the largest owners. From a wider economic perspective, it would not be in the interests of asset managers with a whole of economy view to encourage higher prices in one sector. This would lead to less consumer demand in other sectors or higher input costs for other sectors. These flow on costs could lead to lower aggregate demand and lower performance across a number of sectors, which a fund with diversified holdings would not want to encourage.

In the Azar & Vives (2021) paper<sup>15</sup> discussed earlier, their distinction between “inter-industry” and “intra-industry” common owners is material. Large asset managers and asset owners as inter-industry common owners have fundamentally different motivations from those investors who may have a more control-seeking agenda within a given industry. In a situation, not currently observed, where a fund is a common owner with larger stakes approaching 20% or more, closer attention would be warranted by regulators like the ACCC and ASIC. However, in such situations, current competition and corporate law provides duties and enforcement tools to prevent harm.

Experience reveals that director elections are not held around competitive strategies and directors do not run on platforms to engage in less competitive strategies. Nor is there any empirical evidence that votes by common owners are exercised based on competitive strategy and that directors’ elections are based on following a particular competitive strategy.<sup>16</sup> Asset managers in practice do not nominate directors. Boards rely on board recruitment agencies and appointees are recommended. The Board then presents the relevant nominees to shareholders for approval. Nominee directors do not run a campaign for the AGM. Rock et al (2017) observe that during elections, information about directors is limited to their qualifications, expertise, stock ownership and compensation.<sup>17</sup> Therefore, it is difficult to see how shareholders can deliberately vote on competitive strategy. In the case of senior executives in the organisation, they are appointed by the Board, not by shareholders.

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<sup>13</sup>Jennifer Hill, ‘The Conundrum of Common Ownership’ (Research Paper No 3546886, Monash University Faculty of Law Legal Studies Research Paper, March 2020)

<sup>14</sup> Hill (2020), 9.

<sup>15</sup> Joze Azar and Xavier Vives, ‘Revisiting the Anticompetitive Effects of Common Ownership’ (Research Paper, March 2021).

<sup>16</sup> See also Edward B Rock and Daniel L Rubinfeld, ‘Antitrust for Institutional Investors’ (Research Paper No 17-23, NYU Law and Economics Research Paper, July 2017), 17

<sup>17</sup> Rock and Rubinfeld (2017), 17.



### 3.2. Incentives to reduce competition via remuneration

The remuneration structures that currently exist in listed companies strengthen competition. For independent governance reasons, most board directors do not get performance-based remuneration. However, executives are provided remuneration incentives such as shares and options based on the performance of their firm, not the performance of the whole industry. As part of the remuneration formula, the performance of the company is benchmarked against similar companies, which is an incentive to engage in stronger competition. Therefore, were executives to be acting less competitively to preserve the profitability and market share of other industry competitors, they would be acting to reduce their own compensation, which seems highly implausible.

It has been argued that managers may be incentivised to act in anticompetitive ways via remuneration. It is claimed that managers may not be remunerated for aggressively competing to maximise firm profit but instead their remuneration structure incentivises actions that maximise the total portfolio value of common owners. Connected to this, it is claimed anticompetitive behaviour increased inequality, as passive company managers' remuneration rises while and the share of labour falls. It is argued that these remuneration incentives come in the form of compensating executives using measures mainly driven by market profitability rather than individual corporate performance. This structure supposedly arises because institutional investors prefer managers who maximise industry wide profit rather than maximising the firm profit at the expense of other competitors they may hold in their portfolio. They may discourage remuneration structures that encourage competition at worst, or even in doing nothing provide implicit encouragement at best. Literature such as Anton et al (2021) seek to prove this empirically by looking at the use of Relative Performance Evaluation (RPE) which incentivises managers to outperform other competitor companies, and they suggest this is less likely to be used in oligopolistic industries.<sup>18</sup>

Again however, there is little empirical evidence that institutional shareholders use their voting power to encourage remuneration structures that incentivise a less competitive strategy.<sup>19</sup> Remuneration packages are created by the company's HR management with the help of remuneration consultants; they are not actively created by asset managers. The ASX Corporate Governance Principles and Recommendations, which fund managers expect listed companies to adhere to, recommends under Recommendation 8.1 that the board of a listed entity should have a remuneration committee which has at least three members, a majority of whom are independent directors, and is chaired by an independent director. The ASX notes that remuneration for listed entities in Australia should be designed, *'to ensure that the incentives for executive directors and other senior executives encourage them to*

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<sup>18</sup> Miguel Anton, Florian Ederer, Mireia Gina, and Martin Schmalz, 'Common Ownership, Competition, and Top Management Incentives', (Working Paper No 511/2017, ECGI Working Paper Series in Finance, April 2021).

<sup>19</sup> C Scott Hemphill and Marcel Kahan, 'The Strategies of Anticompetitive Common Ownership' (2020) 129 *The Yale Law Journal* 1449, 1410.

pursue **the growth and success of the entity** without rewarding conduct that is contrary to the entity's values or risk appetite...<sup>20</sup>

Rock and Rubinfeld (2017) state in the American context:

*'First, RPE is not readily observable because we do not know the extent to which compensation committees, in granting discretionary raises, reward relative or absolute performance. Second, RPE has become very popular so that many firms use some form of RPE. Third, there can be substantial differences between expected compensation and realized compensation and it is unclear which will have the greatest effect on incentives. Finally, compensation data, especially over time, has not been reported in a standardized format, and the data provided by commercial services is error filled.'*<sup>21</sup>

Addressing the airline study, Rock and Rubinfeld (2017) point to statements in the United States around airlines' executive compensation statements, which identify as a KPI performance relative to competitors.<sup>22</sup> Indeed Kwon (2016) shows that there was higher use of RPE among firms that exhibited high common ownership.<sup>23</sup> Without concluding too much, this at least reveals that remuneration is unlikely to be a clear mechanism driving a causal link between common ownership and less competition.<sup>24</sup>

In the Australian context, Merhebi et al (2006) examine the association between Australian CEO remuneration and firm performance in 722 firms, and find, consistent with international findings in the US, UK and Canada, that there is a strong positive relationship between CEO pay and performance, where CEO wealth increases by approximately \$1.82 for every \$1000 increase in shareholder wealth.<sup>25</sup> Shan et al (2016)<sup>26</sup> show that between 2001-2021, the largest 300 firms had a mean proportion of 21.4% equity based compensation for CEOs and a median of 20%, with a general upward trend in equity based compensation, which reveals significant incentive for CEOs to engage competitively. Shan et al also survey studies that show that CEO compensation in Australia is found to be positively related to firm size and current stock performance (among other things).<sup>27</sup>

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<sup>20</sup> <https://www.asx.com.au/documents/regulation/cgc-principles-and-recommendations-fourth-edn.pdf>

<sup>21</sup> Edward B Rock and Daniel L Rubinfeld, 'Antitrust for Institutional Investors' (Research Paper No 17-23, NYU Law and Economics Research Paper, July 2017), 24.

<sup>22</sup> Rock and Rubinfeld (2017), 25.

<sup>23</sup> Heung Jin Kwon, 'Executive Compensation under Common Ownership' (Research Paper, Department of Economics, University of Chicago, November 2016).

<sup>24</sup> see also David J Walker, 'Common Ownership and Executive Incentives: The Implausibility of Compensation As An Anticompetitive Mechanism' (2019) 29 *Boston University Law Review* 2373.

<sup>25</sup> Rachel Merhebi, Kerry Pattenden, Peter L Swan and Xianming Zhou, 'Australian chief executive officer remuneration: pay and performance', (2006) 46 *Accounting and Finance* 481.

<sup>26</sup> Yaowen Shan and Terry Walter, 'Toward a Set of Design Principles for Executive Compensation Contracts', (2016) 52(4) *Abacus* 619.

<sup>27</sup> Yaowen Shan and Terry Walter, 'Toward a Set of Design Principles for Executive Compensation Contracts', (2016) 52(4) *Abacus* 619, 65.

It can be observed in the publicly available stewardship and proxy voting policies of Australian fund managers that they express clear views about linking executive compensation to, among other things, the financial and operational outcomes of the firm.

We also understand that proxy advisors used by funds identify relative performance to other firms as part of their evaluation of pay. Importantly, these recommendations do not differ based on whether a company belongs to a concentrated industry or not.<sup>28</sup>

### **3.3. Direct encouragement from common owners to reduce competition**

Another supposed mechanism for common ownership leading to anticompetitive outcomes involves direct anticompetitive influence or pressure from common owners.<sup>29</sup> In the case of incentives for fund managers to directly influence companies to engage in anticompetitive behaviour, large funds, and in particular index funds, have holdings across the whole economy including in different but associated sectors. There is little incentive for a manager to pursue a specific policy for a position in one sector when this may harm another sector.

Indeed, it is difficult to see how they could directly accomplish anticompetitive strategies across a whole range of industries to benefit their portfolio as a whole. It would involve funds having quite detailed involvement in the minutiae of operations in an industry. With the example of an airline industry, fund employees would have to analyse various routes and determine where competition is bad for different routes. They would then need to communicate with management about prices in that particular route, and then somehow make them take their preferred course of action. They would have to then monitor that strategy. It would be an involved process, which would be difficult to do across many industries, involving significant internal firm resources and staff.<sup>30</sup> This would be made more difficult by the fact that within an umbrella funds' management organisation, there would be different fund managers for different investment options, each with their own priorities and incentives. Not to mention that undertaking such a strategy would involve huge legal risks for the fund and its directors in breaching competition law.

It is important to note that no empirical proof exists that funds who are common owners actually engage in mechanisms like a form of coordination between competitors to achieve anticompetitive results.<sup>31</sup> To do this would be a very difficult and complex undertaking and would simply not be worth their while when compared with their primary financial interests to compete with other fund managers over their management fees and customer service.<sup>32</sup>

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<sup>28</sup> Edward B Rock and Daniel L Rubinfeld, 'Antitrust for Institutional Investors' (Research Paper No 17-23, NYU Law and Economics Research Paper, July 2017), 25.

<sup>29</sup> Jennifer Hill, 'The Conundrum of Common Ownership' (Research Paper No 3546886, Monash University Faculty of Law Legal Studies Research Paper, March 2020), 12.

<sup>30</sup> C Scott Hemphill and Marcel Kahan, 'The Strategies of Anticompetitive Common Ownership' (2020) 129 *The Yale Law Journal* 1449, 1421.

<sup>31</sup> See Hemphill and Kahan (2020)

<sup>32</sup> Edward B Rock and Daniel L Rubinfeld, 'Antitrust for Institutional Investors' (Research Paper No 17-23, NYU Law and Economics Research Paper, July 2017), 14.

### 3.4. Conclusion: no clear causal mechanism establishing common ownership causes anticompetitive effects

The purported anticompetitive effects of common ownership are not proven. It is far more likely that company managers across all industries are simply concerned with maximising the value of their own firm without regard to the vague interests of their common minority owners. There is little evidence that company managers believe that they need to act in the interest of shareholders beyond the specific firm's performance.<sup>33</sup> Although Leigh and Triggs (2021) conclude that assuming listed firms seek to maximise the value of their investors' portfolios, then they place the same value on \$3.70 of their competitors' profits as on \$1 of their own, they recognise:

*'All estimates of profit weights depend crucially on the assumption that firms maximise the total profits of their shareholders. **There are multiple reasons why this may not occur, including the possibility that institutional investors have less influence than the model suggests, that institutional investors do not in fact wield their power for anti-competitive ends, or that corporate managers do not acquiesce to such pressure...**In the case of the Australian estimates, the available data also limits the precision of profit weight estimates. All these factors should lead our profit weight estimates to be regarded as merely suggestive; hopefully to be further refined by future research.'*<sup>34</sup>

Thus the conclusions by these studies purporting to show common ownership leads to higher prices and lower output are not definitive, and any major law reform should not be undertaken on the basis of very tentative conclusions at best.

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<sup>33</sup> Hemphill, C. Scott and Kahan, Marcel, The Strategies of Anticompetitive Common Ownership (November 2, 2019). 129 Yale Law Journal 1392 (2020), NYU Law and Economics Research Paper No. 18-29, European Corporate Governance Institute (ECGI) - Law Working Paper No. 423/2018, Available at SSRN: <https://ssrn.com/abstract=3210373> or <http://dx.doi.org/10.2139/ssrn.3210373> 1416

<sup>34</sup> Andrew Leigh and Adam Triggs, 'Common Ownership of Competing Firms: Evidence from Australia' (Discussion Paper No 14287, Institute of Labor Economics, April 2021), 15

## 4. The role of asset managers

### 4.1. The difference between fiduciary investors and control seeking investors

It is important to understand that fiduciary investors and control seeking investors have different economic incentives. It is not enough to say that a fund has common ownership and observe a correlation between common ownership and less competitive outcomes. The different incentives of fiduciary investors and control seeking investors must be considered. In much of the literature, the shares reported do not take this difference into account.

Importantly, fiduciary investors do not buy shares to the purpose of controlling the company. When they engage management, this is for the purposes of good stewardship and not to usurp the management of the company and micromanage its corporate strategy. They invest in thousands of companies for the purpose of generating returns for their clients. They offer various investment options and strategies and may have different reasons for holding particular stocks. Indeed, asset management firms themselves are not a monolithic entity with a single interest. Within an asset management firm, there will be different mandates and investment products with different fund managers, across a broad range of different investment strategies. So while the asset management firm as a whole may hold 5% of a company, within that 5% may be different funds managed by different fund managers within the firm. This fact alone brings into question analysis that common ownership alone, without considering other factors, is a major factor for lessening of competition.

As fiduciaries for their clients, they primarily earn fees on the total assets they manage. Therefore, their financial interests are different to control seeking investors who own shares in the fund for the purposes of having a direct say in the management of the company, including gaining spots on the board. The primary financial incentive for asset managers is competing with other asset managers on the basis of investment performance, fees and client service. Index fund managers in particular compete by effectively tracking an index and on lower costs, so any effort expended from index funds to reduce competition would drive up costs and make them less competitive.

The effort required by funds to be encouraging anticompetitive behaviour in particular sectors through encouraging higher prices or less aggressive competitive behaviour, there is limited marginal benefit when you consider the special financial incentives of asset managers. Indeed, it could be costly for them to implement anti-competitive pressure at the same time there is pressure to cut costs and lower fees. Thus it is difficult to establish that various asset managers and companies would all be acting primarily with an understanding that competition should be lessened. Other factors weigh more strongly toward competition.

## 4.2. The important role of stewardship

Institutional investors, who may be common owners, provide a positive influence on company management through stewardship activities. A greater expectation has developed over recent years that asset managers should engage in stewardship activities. Regulators globally and domestically have spoken about the important role asset managers have in ensuring strong corporate oversight. ASIC Regulatory Guide 128 states:

*‘Effective investor engagement can enhance corporate governance and the long-term performance and corporate value of a listed entity.’*

*‘A fundamental principle of corporate governance is that investors should be able to hold the board—and, through the board, management—to account for the entity’s performance. To do so, investors need to engage with the entity. Effective investor engagement can enhance the long-term performance and corporate value of an entity for all investors’ (RG 128.1).*

As noted before, some have argued that common owners could bring pressure to bear on companies to perform less competitively is via stewardship engagement activities. Azar et al (2018) have argued that the influence of institutional common owners would crowd out the influence of other non-common shareholders whose primary influence would be to maximise the firm’s value.<sup>35</sup> Some of the law reform proposals flagged overseas to deal with the alleged problem of common ownership involve the restriction of engaging in stewardship activities such as direct engagement with management and the exercise of voting rights.

However, institutional investors have an important role in ensuring company managers are accountable and acting in the interest of the firm rather than their individual interest. Managerial theory has long identified the ‘agency costs’ that are associated with the separation between the management of a corporation and their ownership.<sup>36</sup> Institutional ownership can be a useful way of reducing these agency costs. Institutional investors have the resources to engage with managers and provide effective accountability for the actions of managers, which individual retail investors would not have. The importance of stewardship comes into sharper focus with index funds. Because of their inability to divest, it is in the fund’s interest to ensure the long-term success of the companies in which they invest.

Stewardship arises from the fundamental right long recognised in corporate law that attaches to share ownership to vote on issues concerning the firm. Stewardship activities are ultimately undertaken because they are in the interest of the fund’s members. It is the duty of an asset manager to maximise long term value for their clients. Having a good culture of stewardship engagement is important for a system of compulsory superannuation where most Australians will be relying on the long-term performance of companies for their retirement nest egg.

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<sup>35</sup> Jose Azar, Martin C Schmalz and Isabel Tecu, ‘Anti-Competitive Effects of Common Ownership’ (2018) 73(4) *The Journal of Finance* 1513, 1553

<sup>36</sup> see Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, ‘The New Titans of Wall Street: A Theoretical Framework For Passive Investors’ (2019) 168 *University of Pennsylvania Law Review* 17



A study by Hartford et al (2018) concluded that long term institutional investors led to better managers, managerial decisions, and increased returns.<sup>37</sup> A study by Boone & White (year) concluded that long term institutional ownership lowers information asymmetry and increases liquidity.<sup>38</sup> Academic studies have shown that better performance follows ESG engagement. Appel et al (2016) found that on average, an increase in passive ownership (that is, ownership not aimed at control of the company where engagement is limited to stewardship activities) is associated with an improvement in firms' future performance.<sup>39</sup> They also find that with passive ownership, there is an associated increase in board independence.

The recognised value of these activities far outweigh any unintentional and unproven anti-competitive effects in a given sector. Undertaking stewardship activities is not a conflict between the aim of maximizing the profitability of the specific firm and the fund's aim to maximise the profitability of their total portfolio. Borochin et al (2020) conclude in their study that common ownership by long term institutional investors has positive outcomes for individual firms and industry, promoting innovation.<sup>40</sup>

Globally, funds have adopted stewardship codes. FSC members sign up to the FSC Stewardship Code.<sup>41</sup> Ultimately, these codes recognise the desirability of good corporate governance for the long-term success of companies. They recognise the importance of asset managers having a long-term view in investment. This long-term view is particularly important in the context of the objectives of our compulsory superannuation system to ensure that Australians have adequate funds to have a dignified retirement. Good stewardship can help strengthen the confidence of the Australian people in the financial services system.

The FSC Stewardship Code states explicitly the desirability of funds engaging in stewardship:

*'Asset Managers should exercise effective asset stewardship on behalf of their clients. They should encourage the companies in which they are invested to meet the highest standards of governance, as well as ethical and professional practices. Asset Managers should use the tools available to them to encourage improving practices and endeavour to hold boards and management accountable where they fail to maintain acceptable standards. Asset Managers should provide a description of their approach to asset stewardship which includes monitoring and engaging with investee companies and the connection between monitoring, engagement, proxy voting and investment decision-making.'*

Under the code, asset managers are required to disclose their approach to the following stewardship activities:

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<sup>37</sup> Jarrad Harford, Ambrus Kecskes and Sattar Mansi, 'Do long-term investors improve corporate decision making?' (2018) 50 *Journal of Corporate Finance* 424

<sup>38</sup> Audra Boone & Joshua White, 'The Effect of Institutional Ownership on Firm Transparency and Information Production', (2015) 117 *Journal of Financial Economics* 508.

<sup>39</sup> Ian R Appel, Todd A Gormley and Donald B Keim, 'Passive Investors, Not Passive Owners' (2016) 121 *Journal of Financial Economics* 111

<sup>40</sup> Paul Borochin, Jie Yang, and Rongrong Zhang, 'Common Ownership Types and Their Effects on Innovation and Competition' (Research Paper, 2020).

<sup>41</sup> The FSC Standard 23 Principles of Internal Governance and Asset Stewardship can be found at <https://www.fsc.org.au/resources/fsc-standards-and-guidance-notes/standards>

1. monitoring of company performance on financial and non-financial matters;
2. engagement with company management and the board (as appropriate) and escalation of issues in instances where initial engagements have not been adequately responded to;
3. approach to considering Environmental, Social and Governance factors (risks and opportunities) and whether these considerations influence investment decision-making and company engagement;
4. proxy voting (see FSC Standard 13);
5. collaborative engagement with other investors including involvement with industry groups and associations;
6. principles used for policy advocacy including participation with industry groups and associations; and
7. the approach to client engagement, education and communication regarding asset stewardship.

It is clear from the list of activities outlined in the FSC stewardship code that funds that engage in stewardship are primarily interested in the governance of companies. They are not interested in the minutiae of corporate competition strategy. Fund managers are interested to use their voting influence on the behaviour of companies to ensure good governance that impacts on a company's long term financial performance. Indeed voting at general meetings is not usually on competitive strategy and managers have not run of platforms promising to promote a particular competitive strategy. Nor is engagement about pricing. It is around ensuring directors have the appropriate qualifications, executive compensation and aligning it with shareholder returns, long term strategy, climate risk disclosure, corporate conduct, human management, and that ESG issues are appropriately addressed where it is in the long-term interest of the company. Globally, the integration of ESG factors into investment activities has gained increasing importance.

Indeed, the argument that common institutional owners crowd out other investors from engaging in positive influence on the firm is implausible given the observed diversity of ownership. And as Rock (2017) observes, the danger of crowding out influence is minimal because if a firm were pursuing a less competitive strategy in anticipating the interests of their common shareholders but without the common owners actually exercising control, other shareholders and hedge funds would be incentivised to buy larger positions, as they see the share price is lower than it could be, and they could profit off encouraging a more aggressive strategy.<sup>42</sup>

Where there are concerns about undue shareholder activism not being in the long-term interests of the company, this can also be counterbalanced by long term investors whose interests are in the long term success of the company rather than using voting power to push for the popular issues of the day. Appel et al find evidence that a larger ownership stake by passive funds is associated with a 1.6% decline in hedge fund activism.<sup>43</sup> As stated before, with index funds in particular, since they are committed to holding companies on the index whether performing well or poorly, their interest is to ensure good governance. There are different legitimate views on the best long-term interests of the company, and funds approach each issue on a case by case basis in line with their fiduciary duty.

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<sup>42</sup> Edward B Rock and Daniel L Rubinfeld, 'Antitrust for Institutional Investors' (Research Paper No 17-23, NYU Law and Economics Research Paper, July 2017), 26

<sup>43</sup> Ian R Appel, Todd A Gormley and Donald B Keim, 'Passive Investors, Not Passive Owners' (2016) 121 *Journal of Financial Economics* 111



### 4.3. Proxy voting and advice

Superannuation funds commonly retain the voting authority independently of their fund managers, via a contractual arrangement allocating the authority to exercise voting rights. Superannuation funds may also contract out voting authority to fund managers, seeing this as an extension of the role of asset manager, with proxy votes part of the economic asset that they are contracted to manage. Superannuation funds and fund managers have policies on the principles used to guide how they exercise their votes, such as principles on voting preferences, voting considerations around board composition, remuneration, diversity, climate change and ESG matters. Many fund managers also disclose annual voting summary reports. In exercising their voting rights and engaging in associated stewardship activities, funds should be exercising their own judgment in determining what actions are in the best financial interest of fund members.

An important aspect of the stewardship activities of funds overlooked by a lot of literature is the role of proxy advisors and the advice they provide to funds on the exercise of votes. Proxy advisors are used by our members for research, voting advice and recommendations and voting execution, administration and reporting support.

The Committee would be aware that Treasury has recently consulted on reforming the provision and exercise of proxy advice, in order to make it more transparent. Proposals for reform include the disclosure of voting records and to what extent advice from a proxy advisor has been relied on. Transparency around the use of proxy advice would better help policy makers understand how stewardship is carried out. FSC superannuation members are already subject to FSC Standard 13 on Voting Policy, Voting Record and Disclosure.<sup>44</sup> The standard is also relevant to our funds management members as the external fund managers of superannuation funds.

The standard requires superannuation members to disclose the role of proxy advisors in the context of stewardship activities including who has responsibility for exercising votes. Members must disclose the use of proxy voting advisers in the scheme operator's voting policy including the role played by the proxy voting advisers (including whether advice or final decisions), the extent to which the scheme operator relies on the advice and recommendations provided by the proxy adviser when deciding how to vote, and the name and other relevant details of the proxy advisers used. The standard also requires members to disclose the principles used to guide voting decisions including any principles on voting preferences, voting considerations around board composition, remuneration, diversity, climate change and ESG matters, circumstances where the scheme operator may abstain and approach to potentially contentious issues such as shareholder resolutions, instances of voting against management recommendation and resolutions contentious in the media. Members must also publish at least annually a summary of the scheme operator's voting record including where the voting has been inconsistent with the operator's voting policy and the reason for the inconsistency.

Importantly, the Treasury consultation flags options for reform to encourage engagement with proxy advisors and the companies subject to their report. The FSC supports proxy advisors, on whose reports funds rely, engaging with companies and allowing companies to respond to any factual errors and inaccuracies, making any clarifications made by

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<sup>44</sup> The FSC 13 on Voting Policy, Voting Record and Disclosure can be found at <https://www.fsc.org.au/resources/fsc-standards-and-guidance-notes/standards>

companies subject to the report available to users of the proxy advice, provided that this does not impede the timeliness and candour of the underlying advice for which our members pay. The consultation also flags options that may require proxy advisors and the advice they provide to be covered under the general obligations of financial services providers under the *Corporations Act 2001*.

The FSC believes that extending requirements for transparency about proxy voting and the use of proxy advice across the industry would be welcome, and would help policy makers better understand how a more concentrated capital industry would seek to exercise its institutional shareholder voting rights. We believe that any advice given by proxy advisers should be acted on by trustees only if it is in line with their obligation to act in the best interests of their members. Improved disclosure of proxy voting across the industry will help policy makers monitor whether the exercise of proxy votes are occurring in the interests of superannuation members. Importantly, greater transparency on the use of proxy advisors would further diminish any opportunity that the use of voting power is being used to deliberately create anticompetitive outcomes within an industry.

#### **4.4. Conclusion: asset managers and good corporate governance**

While stewardship practices vary, it can include promoting the independence of the board and appropriate compensation, and the disclosure of risks. Moves to restrict the stewardship activities of common owners in an undue manner, such as under law reform proposals floated in literature overseas (explored below), will have a chilling effect on these important stewardship activities.

## 5. Proposed law reform and adequacy of current laws

### 5.1. Adequacy of Australian Law

If there are concerns about the influence of superannuation and other funds on competition, current Australian competition law provides adequate duties and enforcement mechanisms to protect consumers from the harmful effects of anti-competitive conduct.

Section 45 of the *Competition and Consumer Act 2010* prohibits contracts, arrangements, understandings or concerted practices that have the purpose, effect or likely effect of substantially lessening competition in a market. ‘Arrangements’ and ‘understandings’ involve two parties ‘arousing in the others an expectation that he will act in a certain way’<sup>45</sup> or ‘involve the meeting of two or more minds (to adopt) a particular course of conduct.’<sup>46</sup>

We would contend that the mere fact that common ownership exists does not mean a harmful arrangement or understanding exists, particularly at the currently observed levels of common ownership. While an arrangement need not be written down, there is no evidence to infer or establish that company managers feel they had an arrangement or understanding with a common owner fund to act less competitively and to act in the interests of the common owner’s whole portfolio, rather than the manager’s company, particularly when the manager has strong incentives to act in the interests of their company (as discussed previously).

Under Section 45, any conduct has to ‘substantially lessen’ competition in the relevant market. The lessening of competition must be weighty and cannot be insubstantial. This is an appropriate threshold so that the law targets conduct that is truly harmful for consumers. In *Sterling Harbour*, French J stated with regard to whether competition is substantially lessened ‘...there (must) be a purpose, effect or likely effect of the impugned conduct on competition which is substantial in the sense of meaningful or relevant to the competitive process.’<sup>47</sup> Again, due to the common ownership stakes being minority stakes at most of 5-6%, and given the contested academic literature around purported correlation between common ownership and higher prices, we do not believe it is established clearly that competition is substantially lessened by common ownership and therefore that a causal link between common ownership and real harm has been established.

Industries with common ownership identified in Leigh and Triggs (2021)<sup>48</sup> such as banking and insurance arguably do compete over price such as rates and premium, and customer service such as claims. There is no evidence that the competitive process in these industries has been meaningfully impacted by the mere fact of common ownership, or indeed by any stewardship activities undertaken by common owners.

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<sup>45</sup> *TPC v Nicholas Enterprises Pty Ltd (No 2)* (1979) FLR 83

<sup>46</sup> *Top Performance Motors Ltd v Ira Berk (Qld) Pty Ltd* (1975) 24 FLR 286

<sup>47</sup> *Sterling Harbour Services Pty Ltd v Bunbury Port Authority* [2000] FCA 38; (2000) ATPR 41-752

<sup>48</sup> Andrew Leigh and Adam Triggs, ‘Common Ownership of Competing Firms: Evidence from Australia’ (Discussion Paper No 14287, Institute of Labor Economics, April 2021)

Further, there is no evidence that any agreements, understandings or concerted practices exist between common owners and companies to lessen competition in a market and avoid reducing prices. It seems even less likely that firms across an industry would be engaging in concerted practices, engaging in common behaviour to engage in less competitive activity due to shared common owners.

Section 46 of the *Competition and Consumer Act 2010* prohibits a corporation that has a substantial degree of power in a market in engaging in conduct that has the purpose or has or is likely to have the effect of substantially lessening competition in that market or any other market. Having market power itself is not illegal. What is illegal is the use of that market power to engage in conduct that has the purpose, effect or likely effect of substantially lessening competition. It is possible that as superannuation funds consolidate, they will attract greater scrutiny under Section 46. However, as we have already argued, common ownership creating a 'substantial' lessening of competition at current common ownership levels seems unlikely.

No doubt, were there to be a smaller number of superannuation funds holding stakes of double digits in intra-industry competitors (which is what the trend in Australia is at the moment – discussed in the next section), this would legitimately attract scrutiny. However, convincing evidence would still need to be adduced, beyond the correlations in current academic literature, that common ownership has the effect or likely effect of substantially lessening competition.

Further, if large superannuation funds were to begin to take large stakes in several listed companies within an industry, takeover laws under the *Corporations Act 2001* provide a mechanism to protect the healthy functioning of the market. Under Section 606 of the *Corporations Act 2001*, a fund cannot acquire voting securities if it would result in voting power in the company to exceed 20%, unless the acquisition is part of an on-market takeover bid, an off-market takeover bid or a scheme of arrangement. If there is concern that superannuation funds may act in concert as investors, collectively using their voting power in the same companies within an industry in an inappropriate way (such as inappropriate activism that may go against the long term financial interests of the company or to influence actions that would benefit their shareholders financially in a greater way than other shareholders), current law as well as ASIC RG128 on *Collective Action by Investors* deal comprehensively with any issues that would arise. ASIC RG128 in particular deals with situations where there may be an association between investors and there is the acquisition of a relevant interest.

If there were an explicit arrangement between a fund and several company managers to engage in less competitive conduct, the law already prohibits cartel conduct including conduct that restricts output and inflates prices.<sup>49</sup> No suggestion has been made that company managers in particular industries are actually engaging in cartel conduct due to common ownership. The ACCC has the enforcement tools necessary to investigate and

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<sup>49</sup> *Competition and Consumer Act 2010*, ss45AA, 45AF, 45AG, 45AJ, 45AK

break apart cartels with their investigatory powers and ability to refer cartel conduct to the Director of Public Prosecutions.

Under current corporations law, the control of the company is ultimately in the hands of the board and their agents. In a corporation, ordinarily, management decisions are made by people who are separate to those who own the company. Shareholders do not have the ability to make day to day decisions in execution of the firm's strategy.

Under Section 181(1) of the *Corporations Act 2001*, directors and their agents ultimately have a duty to act in the best interests of the company. They must act in the best interests of the company as a whole, and cannot act in the sole interests of minority shareholders. If there was proof that managers were acting to maximise the value of the portfolio of common owners rather than primarily in the interests of their company, they would be held liable. Further, directors have a duty to act for a proper purpose under section 181(1)(b). This means they must exercise their powers for the purpose for which they are intended, not for a 'collateral purpose'<sup>50</sup> such as using their powers to advance their own personal interests in responding to an investor.<sup>51</sup> Thus current directors' duties would prohibit the scenario posited by some literature that company directors may be incentivised to act in the interests of minority shareholders.

If institutional shareholders were to engage in actions that direct company directors to execute a particular strategy that has the effect of lessening competition, they might be characterised as acting as shadow directors, and in some circumstances liability could be extended to them as shadow directors if they are in breach of the duties imposed on directors under the Act.

## 5.2. Proposed reforms in the United States

Academic literature from the United States has suggested that some form of regulatory intervention should be applied to horizontal ownership to combat potential anticompetitive effects. The mere fact there is horizontal ownership has been argued as causing anti-competitive outcomes that are unlawful. In the US context, Elhauge has suggested that enforcement could occur under existing US anti-trust laws such as Section 7 of the *Clayton Act* and Section 1 of the *Sherman Act*. It is important to note that policymakers have not chosen to implement these proposals.

### Taking action in concentrated industries

Elhauge has notably proposed that the law should prevent common ownership where market concentration is measured to occur in a market with an MHHI above 2500 and result in a  $\Delta$ MHHI above 200. MHHI estimates the impact of common ownership on market concentration and  $\Delta$ MHHI captures the extent to which competitors are connected by

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<sup>50</sup> *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

<sup>51</sup> See *Advance Bank v FAI* [1987] 9 NSWLR 464 and RG 128.63

common ownership and control.<sup>52</sup> Where MHHI is above 2500 and  $\Delta$ MHHI is above 200, Elhauge suggests that regulators and those affected by higher prices in an industry with common ownership could bring an action for anticompetitive conduct against common owners. However, as Lambert and Sykuta (2019) argue, using MHHI based thresholds are wrought with difficulties for regulators seeking to bring enforcement action.<sup>53</sup> They would need to evaluate complicated econometric evidence as to whether horizontal ownership raised or was likely to raise prices and the level of harm that caused. This is correlative at best. Having determined whether there is economic harm, how would they allocate liability among institutional investors. Would a court need to impose liability on all diversified institutional investors?

Using complex thresholds such as the HHI or MHHI to determine potential liability would also be problematic for the ordinary investment activities of funds.<sup>54</sup> Perversely, funds would need to put resources into monitoring the level of a markets' MHHI and  $\Delta$ MHHI in order to avoid liability. That is, they would need to closely monitor market shares of participating firms in a sector, the percentage ownerships of investors in a given sector and the ownership percentages of non-diversified shareholders. This would be an incredibly complex task. This is made more difficult because the HHI can fluctuate based on quick and unpredictable movements in the market, with market shares of individual firms changing based on many factors not related to common ownership.<sup>55</sup>

A paper by the Committee on Capital Markets Regulation points out a scenario where a small change in institutional ownership can increase MHHI dramatically and lead to the impression that it is a highly concentrated industry:

*Suppose an industry has an MHHI of 2136 (below the 2500 threshold). The MHHI of that industry can spike from 2136 to as much as 14 106 if a single non-common owner with a 10% stake in a single firm in that industry decides to sell their shares – even if there is no other change in ownership by common owners of firms in the industry. Exposing institutional investors to antitrust liability from investing in multiple firms in an industry simply because another institutional investor made the*

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<sup>52</sup> The MHHI derives from the HHI. If a firm has a complete monopoly (100% market share), the HHI is  $100^2$  or 10,000. In a duopoly, the HHI would be  $50^2 + 50^2$  or 5000. Where there are many small competitors within a sector, then HHI approaches zero. The MHHI accounts for ownership overlap. If there is no overlap MHHI = HHI. But where there is common ownership, MHHI is greater than the HHI. The difference between MHHI and the HHI is  $\Delta$ MHHI. For instance, in a duopoly where the HHI is 5000, if Fund X owned 100% of both firms, MHHI would be 10,000 (equal to HHI). So the  $\Delta$ MHHI would be 5000.

<sup>53</sup> Thomas A Lambert & Michael E Sykuta, 'Are the remedies for the common ownership problem worse than the disease? Assessing the likely decision and error costs of proposed antitrust interventions.' (2019) 2(2) *CPI Anti Trust Chronicle* 1.

<sup>54</sup> See Andrew Leigh and Adam Triggs, 'Common Ownership of Competing Firms: Evidence from Australia' (Discussion Paper No 14287, Institute of Labor Economics, April 2021), 17-18 for a discussion on HHI and how industries seen to be concentrated under MHHI aren't under HHI.

<sup>55</sup> See Committee on Capital Markets Regulation, Analysis of Common Ownership Proposals, 7



*independent investment decision to sell their stake in one company in that industry could lead to a highly unstable market.<sup>56</sup>*

They also show that the measurement for an industry to receive greater scrutiny for concentration may be too inclusive so that even an industry that is highly competitive with minimal common ownership may be deemed as too concentrated:<sup>57</sup>

*‘Suppose an industry has 100 competitive firms, each with a 1% market share. The HHI for the industry is 100, far below the current 2500 threshold for antitrust concerns. Further suppose that there are only three institutional investors with common ownership and that they each own 1% of the equity in each of the 100 firms (3% common ownership in aggregate across the three institutions). These conditions would produce an MHHI of 10,000, well above the 2500 threshold used by Elhauge.’<sup>58</sup>*

It would be odd for strong enforcement action or regulation to be taken on a measurement that does not necessarily reveal that harmful concentration is occurring. Such an approach would in essence assume that there are anticompetitive effects because an industry is deemed concentrated, despite a lack of evidence.

With these thresholds being so volatile, it would become problematic for funds to manage their holdings. It would change the decision-making process of investors. They would also need to be constantly taking action to ensure their holdings could not be characterized by a regulator or court as having anticompetitive effects, rather than primarily focusing on what is in the best financial interests of their members. This would be made more complicated by the fact that firms and investors regularly enter and exit an industry, so it would be difficult to track which sectors are ‘oligopolistic’. In short, funds would need to spend resources constantly checking their positions. They could be subject to market manipulation as other actors take positions to crowd out another fund’s position in order to force them to divest. It is conceivable such a radical regulatory approach would necessitate regular huge sell offs by institutional investors of equity in major companies, restricting the ability for companies to raise capital, as well as creating issues of market stability.<sup>59</sup> This would also result in the inefficient allocation of capital and increase costs for investors<sup>60</sup> as investors would avoid owning stakes in companies in industries that are close to the 2500 threshold.

The cost of this would be larger than any benefit mitigating the tenuous risk of anticompetitive effects. The complexity of the measurement of capital concentration, and ambiguity of harm created with various common ownership concentration measurements

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<sup>56</sup> Committee on Capital Markets Regulation ‘An Analysis of Proposals to Restrict Institutional Ownership’ (2019), 7

<sup>57</sup> Committee on Capital Markets Regulation ‘An Analysis of Proposals to Restrict Institutional Ownership’ (2019), 5

<sup>58</sup> Committee on Capital Markets Regulation ‘An Analysis of Proposals to Restrict Institutional Ownership’ (2019), 7

<sup>59</sup> Committee on Capital Markets Regulation ‘An Analysis of Proposals to Restrict Institutional Ownership’ (2019), 6

<sup>60</sup> See Committee on Capital Markets Regulation ‘An Analysis of Proposals to Restrict Institutional Ownership’ (2019), 7

means clear harm needs to be demonstrated before any radical regulatory interventions are contemplated.

### **Restricting common ownership and the importance of diversification**

Another proposed intervention includes a law that prevents investors in identified industries either

- a) holding stocks above a threshold (eg: more than 1% of aggregate equity) in more than one firm in an industry deemed oligopolistic<sup>61</sup> or
- b) holding stocks in more than one firm within an industry deemed oligopolistic.

Both these options prevent proper diversification of investments. It is an essential risk management tool and fundamental to ensuring sustainable long term returns for fund members. It means that a portfolio is not overly exposed to negative impacts that may arise from the poor performance of a single stock, i.e. idiosyncratic risk. Modern Portfolio Theory, which identifies the need for diversification in order to mitigate risk by spreading assets across companies and sectors, is well established as foundational to investment.

It is argued that investment losses due to lack of diversification would be minimal because diversification could still occur across different industries. Investors could also buy different funds if they wanted intra-industry diversity. But as can be easily understood, exposure to a single company within a sector is indeed a risk and there would be significant consequences for returns for members.

Two given companies may be intra-industry rivals, but there is no guarantee they will both succeed in the same way. Indeed, within an industry, one competitor could be considered a growth stock while another could be considered a defensive stock. Onerous restrictions on the ability of institutional investors to diversify within a given industry would increase the risk of loss for the fund's members. For instance, an institutional investor may be invested in multiple companies in a given sector such as airlines. If they were only allowed to invest in one airline to avoid horizontal shareholding, the failure of that airline during a recession or industrial dispute would be detrimental to the fund; a situation that could have been mitigated had it invested across a variety of airlines, many of which would survive and succeed in the long term. It is in the interest of retail fund members that their savings be invested in a responsible, diversified manner.

If option a) were adopted, a fund would have the same 1% exposure to companies within an industry, regardless of whether they thought one company was better value than another. Superannuation fund members would be foregoing billions of dollars in potential returns. If proposal b) were to be adopted, then institutional investors would be forced to pick single winners in each sector and would end up with being unable to mitigate the risk that they underperform. In a compulsory superannuation system, these outcomes are unacceptable. Having to choose a single firm within a sector or being compelled to have the same low exposure in companies across the sector, could mean substantial differences of returns.

It might be argued option a) provides a safe harbour, so that a fund can diversify and own 1% of Company X and 1% of Company Y, but could not increase their ownership above 1% unless they divested from every other company. But if such a law were to be introduced,

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<sup>61</sup> See Eric A. Posner, Fiona Scott Morton, & E. Glen Weyl, 'A Proposal to Limit the Anticompetitive Power of Institutional Investors' (2017) 81 *Antitrust Law Journal* 669, 669-70



funds would have to divest hundreds of billions, potentially trillions of dollars of stock in companies, creating wide market disruption. In the US context, the Committee on Capital Markets estimate that the need for common institutional investors to sell stock so that they hold only 1% common ownership in companies would mean the sale of at least \$5 trillion of stock of the 443 largest US public companies, which is 23% of the market cap.<sup>62</sup>

Hemphill and Kahan outline why such a proposed restriction would make the task of investment management incredibly difficult:

*‘Consider the implications of such a proposal for large investment advisors, whose holdings would exceed the one-percent limit. For advisors to active funds, being confined to a single stock in an industry would be extremely problematic. Large advisors manage assets in different funds and for a large number of clients, and neither funds nor clients would be able to agree as to what stock to pick. Fund investment choices are affected by the fund objectives—growth or value, large-cap or small-cap—and the views of the fund portfolio manager. Since active funds are marketed based on these objectives and on the track records of fund portfolio managers, limiting all funds managed by the same advisor to a single stock in an industry would place it at a severe competitive disadvantage, compared to funds managed by smaller advisors that would not be constrained by the one-percent limit.’<sup>63</sup>*

Further, proposal b) would create onerous costs on funds, and by extension fund members, and lessen competition in the super and funds sector. Firms would have to undertake complex and expensive analysis when trying to pick a winner and decide which industries are the industries where they can only acquire one company. Were a firm to decide to change its chosen company within a concentrated sector, it would have to offload its large position which could have consequences for the capitalization of the company creating chaos in the market. It would make the ordinary business of asset management radically difficult.

For both these options, funds would have to constantly monitor whether they will need to divest from positions if an industry suddenly becomes concentrated. Products such as index funds could no longer be offered as they would be unable to take positions that mirror indexes that include competitor firms. It would also affect active funds as the firm as a whole would have to decide on a single firm in a given industry to invest in for all their funds. This would reduce their ability to offer different funds with different investment strategies, reducing choice for consumers.

The proposed restrictions could also conceivably apply to an entire fund’s holdings rather than the individual funds offerings, which would prevent a diversity of product offerings. A manager may be restricted from pursuing different strategies via different investment options, due to restrictions applying to investing in different competing firms. For instance, were a fund management firm to decide that for its balanced option it were to invest in X stock, it could not then for its growth option invest in Y stock. To get around this, funds would have to restructure via splitting into multiple independent funds, so that a single fund only holds 1% of a stock under option a) or has holdings in a single company within a sector under option b). Retail investors would in effect have to become their own active fund managers; in trying to select funds they would have to try to work out which individual

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<sup>62</sup> Committee on Capital Markets Regulation, 16

<sup>63</sup> C Scott Hemphill and Marcel Kahan, ‘The Strategies of Anticompetitive Common Ownership’ (2020) 129 *The Yale Law Journal* 1449, 1451

companies in each concentrated sector are the ones most likely to perform well. Running a fund would become more expensive, increasing fees for consumers. An inefficient funds management industry would be created, without the benefit of economies of scale.

Diversification that funds undertake within sectors does not create significant, if any, negative anticompetitive harms. The importance of portfolio diversification for the savings of Australians clearly outweighs the cost of unobserved and unintentional anticompetitive behaviour. Given that the goal of our retirement system is to ensure that Australians have enough to retire on, the ability to properly diversify in the best financial interests of members should not be impeded. The potential mitigation of anticompetitive effects is ambiguous at best, at the cost of the clear benefits of diversification.

### Restricting stewardship activities

Finally, another proposed reform is a 'safe harbour' option for passive funds. It is suggested that shareholders with horizontal ownership holdings could be permitted to have horizontal holdings, but they must be restricted from exercising voting influence or communicating with corporate managers and directors.<sup>64</sup>

As we have already argued above, stewardship is an important part of ensuring long term value for asset managers' clients. Restricting the ability of minority institutional shareholders to vote would fundamentally change the nature of a shareholder as traditionally understood in corporations law. Shareholding generally attaches to it a right to vote at shareholder meetings. As such, this proposal would effectively disenfranchise minority shareholder interests. By extension, the superannuation fund clients of asset managers would be disenfranchised, which ultimately means everyday Australians seeking returns for their retirement savings. This proposal could also have the effect of increasing the power of activist hedge funds. It is in the best financial interests of Australians that the managers of companies in which their savings are invested are being held accountable for good corporate governance.

As the Committee on Capital Markets Regulation noted:

*'The effects on corporate governance could be dramatic. For example, public companies could become more exposed to short-term pressures, as activist investors could buy significantly smaller stakes in a public company to attain voting power. The purely passive safe harbor could also serve to insulate management from beneficial institutional pressures. While asset managers vary their voting strategy across firms on governance issues, they tend to support greater board independence, oppose antitakeover provisions, and oppose unequal voting rights, as occurs when firms maintain a dual class share structure. Accordingly, firms with greater ownership by index funds, for example, are found to have more independent directors than firms with less index fund ownership. Index fund ownership of firms also contributes positively to the removal of takeover defenses (i.e. poison pills), which have been shown to have negative consequences on firm performance and shareholder returns. In addition to improving the corporate governance of firms, active engagement by index fund owners also contributes positively to firm performance. Firms with higher index fund ownership are found to have significantly improved returns on assets (ROA). Indeed, prominent legal experts argue that*

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<sup>64</sup> Eric A. Posner, Fiona Scott Morton, & E. Glen Weyl, 'A Proposal to Limit the Anticompetitive Power of Institutional Investors' (2017) 81 *Antitrust Law Journal* 669.

*regulators should in fact be encouraging additional shareholder engagement by institutional investors*<sup>65</sup>

While it is possible that common owners could lobby and facilitate cartel behaviour through engagement with management, this would clearly be illegal under current laws.

### **5.3. Conclusion: Law reform needs clear justification**

Any recommendations for law reform by the Committee would be premature. As we have argued, it seems unlikely under currently observed levels of common ownership that directors would be incentivised to act in the interests of maximising the total portfolio of the common owner rather than their company.

The proposed law reform interventions overseas would have negative consequences to address a problem for which there is no clear consensus that a problem exists. They would undermine the need for funds to diversify, undermine important stewardship activities and undermine fundamental shareholder rights.

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<sup>65</sup> Committee on Capital Markets Regulation, 15

## 6. Regulatory settings contributing to common ownership

The Committee should support policy settings that enable Australian investors to save for their financial goals and retirement with the choice of various diversified investment products. It is important to ensure that the superannuation and funds management industry remains competitive.

In the superannuation fund context, current Government policy settings are promoting mergers and maintain that larger funds tend to provide better outcomes to members. This is a competing policy position to that of this inquiry.

Evidence in the superannuation sector indicates a trend of consolidation, which may lead to the theoretical issues with common ownership becoming a greater risk. A recent Rainmaker Superannuation Benchmarking Report<sup>66</sup> shows that the number of superannuation funds in Australia has halved from 389 to 179 in the past decade. The Your Future Your Super reform is also likely to support industry consolidation, whereby trustees at risk of failing the performance test in two consecutive years may seek to merge with another superannuation fund, leading to greater market concentration. The Rainmaker research indicates that by 2025, Australia's 10 biggest super funds will hold 80% of the superannuation market.

There are other Government policies that are, or might be, promoting market concentration in investment products, which will mean there will be a smaller number of large funds:

- The Design and Distribution Obligations (**DDO**), which commence on 5 October 2021, will impose onerous reporting requirements on product distributors (including financial advisers and investment platforms). These requirements will actively encourage distributors to limit the number of products they offer or advise on. As a result, advisers and platforms may cease to advise or distribute smaller superannuation funds and managed funds.
- The high and increasing costs of compliance and regulation on products discourages new market entry, encourages mergers between smaller providers, and discourages existing providers from issuing new competing products. This includes:
  - The high cost of regulatory cost recovery fees
  - The ever-increasing regulatory burden from the DDO, the Financial Accountability Regime (FAR), Internal Dispute Resolution, and extensive tax reporting requirements under the AMMA/AIIR/SDS.
  - The short timeframe where Managed Investment Trusts (**MITs**) are able to access the MIT startup tax concession, making it unviable to add new MITs to the Australian market.

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<sup>66</sup> <https://www.rainmaker.com.au/media-release/big-super-funds-getting-bigger-squeezing-out-competition>

## 7. Encouraging infrastructure investment via infrastructure investment vehicles

We submit for the Committee's consideration a proposal the FSC has previously raised which we believe would help encourage greater investment diversity, reduce capital concentration and boost investment in infrastructure.

We know that for some time, Australia has had weak investment levels, and this will only be exacerbated due to the economic downturn caused by COVID-19. While State and Federal Governments have provided substantial funds for infrastructure investments, this can be enhanced by investment by private capital. Given that infrastructure can provide competitive market rates of return, we believe private capital can be better encouraged to invest in infrastructure via the creation of investment vehicles.

Under our proposal, governments could package assets into vehicles with unit pricing which would enable all sizes of institutions and superannuation funds to invest in assets that were:

- more readily investable;
- more liquid (in terms of their proportional holding);
- generating returns which are a truer reflection of competitive capital; and therefore
- provided at a lower cost to the consumer.

The vehicles would need to be either:

- closed ended, with capital being issued and redeemed at the discretion of the vehicle operator not the investor, or
- redeemable by the investor very infrequently (eg quarterly).

However, the units in the fund would be tradable. Governments could also retain interests in the asset by holding a stake in the vehicle. A vehicle could hold one large asset (similar to Sydney Airport) or it could hold a range of infrastructure assets for greater diversification and stability of return. Vehicles could solely own existing infrastructure assets (either a single asset per vehicle or a mix of assets), invest in upgrades of existing infrastructure, or could be involved in the development of new (greenfield) assets. The proposal provides flexibility to partner with Government such as through the Government pre-packaging a development opportunity that it markets to an infrastructure vehicle or through a vehicle going to a government with a fully developed proposal.

The creation of these vehicles would also have a great national security benefit, addressing concerns about foreign ownership of key infrastructure assets. Under these proposed models the capital from overseas investors would be supported, provided the investment decisions and actual control over the physical asset lies with the fund manager and its locally employed staff. This means foreign ownership does not equate to foreign control. For all but the most sensitive of assets, local ownership and control is a more important factor than source of funding.

There are other significant benefits of such a model of infrastructure investment. A broader investment pool with more diverse assets, including more mature assets with a proven income stream, would increase the range and volume of investor capital which could be attracted as a result of the broader diversification benefits. This would lower the risk profile and enhance attractiveness to smaller investors. This could also broaden the appeal to smaller Australian investors, reducing the need to seek investment from foreign sources in

critical assets which are sensitive to the community. That said, the funds could still have portfolio investment from overseas, representing small proportions of the underlying assets that do not raise foreign investment questions. This approach would generally not work under the current model where only large investment parcels are involved in infrastructure investment.

Encouraging broader equity investment could also reduce the risks of projects being excessively geared and may spread the risk between contractors, equity investors and government. Risk should be allocated to those who are best placed to price and deal with them.

This would be the start of the development of a “market” for infrastructure assets in Australia, similar to our well-established debt and equity markets. Such an infrastructure market would mean that, in the long run, the Australian financial market would be deeper, more diversified and more liquid.

A well-developed market-based mechanism would lead to decreased costs to infrastructure users (the consumer) and improved efficiency of infrastructure as a result of:

- Government foregoing maximising their returns;
- A more competitive capital allocation framework would decrease the rate of return which would need to be provided to investors;
- Lower infrastructure transactional costs.

By providing a mechanism for investors to seek diversification, an infrastructure market would improve the prospects for both greenfield and brownfield developments being funded and undertaken because investors would be able to select the appropriate investment mix of existing, income producing assets with new developments. This spreading of development and trade-up risk would be particularly appealing to investors.

## 8. Conclusion

Common ownership arises because of the fundamental need for funds to diversify investments on behalf of their members and minimise financial risk. Diversification is in the best financial interests of everyday Australians who have their retirement savings in superannuation funds.

There is little to no clear evidence that common ownership at currently observed levels create anticompetitive outcomes. Ultimately, company directors owe fiduciary duties to their own companies and they have financial incentives to act to maximise their company's profit. There is little evidence that any incentives provided by common ownership are strong enough that company managers feel the need to act anticompetitively in pursuance of the interests of minority shareholders.

Further, asset managers do not seek to exercise control of the companies they invest in. They engage in stewardship practices because it is ultimately in the interest of fund members. This is important in the context of our compulsory superannuation system, where it is important for the savings of Australians that the management of companies are held to account.

We submit that any concrete law reform would be premature. Proposals to restrict ownership to low levels and to restrict the ability for funds to engage with company management would have greater costs for Australians and their savings than any purported benefit.