Common Ownership, Some Thoughts: An Informal Memo in Reply to Einer Elhauge

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This extremely rough and informal draft memo is intended as a reply to Professor Einer Elhauge, who wrote a wonderfully argued and supremely comprehensive piece on the evolving debate over "common ownership". Elhauge's article stands as a seminal contribution to this discussion, alongside pieces by John C. Coates; Posner, Morton and Weyl; Hemphill and Kahan; Rock and Rubinfeld; Bebchuk and Hirst, and of course Azar, Schmalz and Tecu. I would like to raise some objections to the alleged anti-competitive effects of common ownership which I do not believe have emerged thus far in the debate. I will not attempt to respond to Elhauge's article in its entirety, only to a tiny fraction of the ideas broached. This informal memo assumes a high degree of familiarity with the arguments being made on each side. For a more general treatment of the subject, please see "Index Funds: Promise or Peril" on Cato at Liberty.

I will be borrowing some terminology from Hemphill and Kahan, who refer to common owners as "CCOs" and non-common owners as "NCOs". I will not attempt to rehearse their objections here, and would instead commend their article "The Strategies of Anti-Competitive Ownership" to everyone. Rather, I would like to add some original contributions by using accessible arguments that anyone acquainted with the prisoners' dilemma may understand. Therefore, when I use the word "cooperation" below, it is not intended to mean explicit collusion either between a firm's managers and owners or between the managers of different firms. Elhauge cites an excellent article by Jose Azar which demonstrates that this need not be the case for management to act in an anti-competitive manner.

1

Let's recall the core insight from the prisoner's dilemma: unilateral defection > multilateral cooperation > multilateral defection > unilateral cooperation.

Imagine an industry with five publicly-traded incumbent firms A-E. Management at each firm may choose to engage in anti-competitive behavior vis-à-vis other firms in the industry (cooperate), or pro-competitive behavior (defect). What the discussions of "commonw ownership" have so far neglected is the fact that the only way to achieve supra-normal industry profits via the anti-competition strategy (cooperate) is if CCOs can induce this strategy multilaterally *among all five firms*. If CCOs successfully induce cooperation at firms A-D, but management at Firm E proves recalcitrant and the CCOs do not have the requisite votes to forcibly remove it or otherwise modify its behavior, Firm E will then be able to undercut the profitability of the anti-competitive strategy of firms A-D, either by increasing output which the non-competing firms have restricted, or by charging competitive prices below the supra-competitive prices charged by the non-competing firms. Thus, the expected value of the anti-competition strategy is the payoff to full cooperation multiplied by probability of the following independent events: (Successfully induce cooperation at Firm A) x (Successfully induce cooperation at firm B) ... (Successfully induce cooperation at Firm E). Or, P^N, where P is the probability of inducing cooperation at a given firm and N is the number of publicly-traded incumbents in an industry.

Moreover, the timing of this sequence of inducements raises further questions as to its plausibility. Unless pulled off simultaneously, this strategy will have possibly dramatic intra-industry redistributive effects until it is completed. If firms A-E are initially competing with one another, but CCOs are successful at inducing anti-competition in Firm A first, Firm A has unilaterally disarmed in the face of continued competition from Firms B-E. Firm A is now less profitable, and Firms B-E are more profitable, a wash for CCOs. But the difficulty in inducing Firm B to practice anti-competition is now greater, and, even over-

coming this, Firm C will be more difficult still. The events in the calculation above are not independent, and in fact the probability of 5 successes is *smaller* given the dynamics discussed below.

The NCOs at firms B-E now enjoy an increased profitability that is contingent on their respective firm's continued competition. These NCOs now stand to lose more if their firm is similarly induced to disarm, and these rents only increase with every successive firm which forfeits a chunk of its marketshare by reducing competition. Let's bring this full circle to the point at which Firms A-D have been successfully induced to cooperate by CCOs, with Firm E as the last holdout. The supra-normal profits NCOs at Firm E enjoy as a result of its unilateral defection from anti-competition are now enormous, far higher than the pro-rata share enjoyed by Firms B-E when only Firm A neglected to compete. As the rents at stake over managerial and board elections increase, the incentives for even small and dispersed NCOs to inform themselves and vote in their interests (continued defection) increases. CCOs would need not merely a plurality of votes and hope to be the median vote, but a raw majority to muscle out the unified opposition of NCOs at Firm E so that they can finally enjoy the industry-wide profit maximization that results from the multilateral cooperation of all industry incumbents. This majority cannot simply comprise CCOs generally, but must be made of CCOs with sufficiently balanced holdings across all incumbent firms (e.g. index funds) such that they on net gain from Firm E's capitulation. In this scenario, where Firm E is the last holdout, a CCO invested in firms C, D, and E will on net lose if multilateral cooperation is achieved. How many publicly traded firms today have a majority of their ownership composed of index funds, as opposed to a mere plurality?

Finally, having accomplished complete inducement of the industry, multilateral cooperation is not an equilibrium. Every activist investor now faces the

potential of supra-normal profits if they can "crack" just one incumbent firm and induce it to compete. They will be incentivized to incur costs discovering which firm has the weakest voting coalition of CCOs, the straggler in the herd that the wolves pounce on. Moreover, much of the treatment of common-ownership neglects the possibility of de novo entry into the industry. Even if we assume that the industry is characterized by high fixed costs of entry (whether natural or artificial/regulatory barriers), the supra-normal profits waiting to be taken by an entrant may be even higher. The frustrated NCOs at incumbent firms would provide an eager source of capital, as their individual returns would be higher from a firm practicing unilateral defection vs the multilateral cooperation of the incumbents. A private entrant that successfully employs this strategy and then IPOs as its marketshare expands (although its incentives to stay private would be massive) would eventually itself be acquired by the industry's CCOs. But until its management is also induced to give up its enormous rents, the anti-competition strategy will depress industry-wide valuations vs. allowing the incumbents to remain competitive in the first place.

2

The plausibility of this strategy becomes more precarious when one entertains the possibility that merely attempting to achieve multilateral cooperation imposes costs on the CCOs. As Bebchuk and Hirst point out, the incentives at an index fund are such that any value which accrues to its portfolio must be multiplied by its miniscule fees (average 0.12%) to arrive at the value that it is willing to incur in inducing said appreciation. As I have just noted, this value must then be further multiplied by P^N where P is the independent probability of successfully inducing a given firm in an industry to restrict competition, and N is the number of publicly-traded firms in the industry. If Firms A-D are

successfully induced but Firm E holds the line, the industry as a whole does not enjoy supra-normal profits, and the costs of inducing Firms A-D are squandered.

Elhauge makes the case that for those governance decisions which arise commonly across firms in a fund's portfolio and that can be swiftly typologized as "pro-competitive" or "anti-competitive", the costs of casting an anti-competitive vote are zero or even negative. In this way, he circumvents Bebchuk and Hirst's objection, which applies only to idiosyncratic firm-specific decisions. But again, the incentives to be the unilateral defector which arise endogenously in a scenario of multilateral cooperation mean that management will use its remaining degrees of freedom to subtly subvert the CCO's inducement. Even if CCOs successfully attenuate the relationship between management's compensation and the firm's valuation, a sufficiently large portion of the market lying unguarded by tamed competitors will be a tempting prize.

The mechanism by which management is induced to follow anti-competitive practices without explicit cooperation or communication with CCOs or with other incumbent firms, which Elhauge cites heavily in the beginning of his article, stems from a formal model by Jose Azar. Management wants to maximize the number of votes it receives on a given resolution, and so proposes alternatives to the status quo with an eye toward maximizing this function. Assuming that managers know the extent to which their owners comprise CCOs with horizontal shareholdings, they will naturally be induced to propose alternatives which maximize industry-wide profits, with nary a word of pressure from the CCOs themselves.

But this result only obtains in instances of symmetrical information (those practices that may be easily typologized as pro or anti-competitive, e.g. executive compensation). For those votes pertaining to idiosyncratic, firm-specific decisions, CCOs will be at an informational disadvantage vis-à-vis management

in conformity with the classic Berle-Means paradigm. How are CCOs to vote on such issues? Azar's model does not account for the costs shareholders must incur in adjudicating between the status quo and a proposed alternative as to which maximizes aggregate industry profits.[1] If CCOs are unwilling to bear any costs and instead vote randomly, they vanish as noise over the population of such votes, meaning that NCOs, with an interest in pro-competitive idiosyncratic firm-specific decisions and concentrated holdings sufficient to incentivize them to inform themselves, will carry the day on average. Can CCOs simply use the votes of NCOs as a costless proxy, always voting against them? No, because CCO and NCO interests do not always diverge. They are united against managerial rent-seeking which transfers wealth from shareholders, as a bloc, to management and which doesn't redound to the benefit of other firms in the industry. If activist NCOs have identified an overly extractive management and are initiating a campaign against them, the CCOs would be foolish to stymie them in this endeavor. Ironically, the very compensation structure which CCOs advocate makes such a scenario far more likely. There also emerges the possibility of collusion between activist investors and management, where multidimensional micro decisions are structured such that they increase managerial rents (e.g. perquisite consumption) and increase competition at the expense of other firms in the industry, undetected by uninformed CCOs.

We arrive at an indeterminate result. If CCOs are too successful at blunting managerial incentives to increase share value via easily observable macro-decisions, they will invite enough shareholder-to-management wealth transfers via costly-to-scrutinize micro-decisions that harm them, qua shareholders, on net. Moreover, whereas the gains to anti-competitive macro-decisions are contingent on full cooperation by all incumbents, the firm-level managerial rent-seeking at the micro level is costly to CCOs whether management at other firms

[1] I would like to thank Professor Azar for clarifying this for me in an email exchange.

engages in it or not. On the other hand, if CCOs insufficiently diminish the link between managerial compensation and firm performance, management will be incentivized to pursue competition via idiosyncratic micro decisions. If CCOs then incur costs in monitoring management for such decisions, and thereby cast informed anti-competitive votes, such costs will be wasted if a single firm resists or shakes loose of such constraints and upsets the anti-competitive equilibrium. Finally, from the perspective of a CCO, incurring the costs to cast informed anti-competitive votes on such micro-decisions represents a public good to the other CCOs who benefit. Why not be rationally ignorant, especially given the miniscule marginal benefit articulated by Bebchuk and Hirst?

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