FP COMMENT

Institutionalized power conflicts

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In any major public corporation, a small number of institutional investors will tend to own a significant portion of the company's shares. This poses a number of new, relatively unaddressed, public policy challenges Jewel Samad/AFP/Getty Images

Fund managers purporting to compete with each other often have large common ownership positions

Franklin Delano Roosevelt's famous admonition – "Great power involves great responsibility" – is a clarion call today when thinking about the implications of the dominant (and growing) share ownership position of institutional investors (including large money-managers, public pension plans and sovereign wealth funds) in global capital markets. Given their size, it is difficult for them not to "own the market." This leads to a large number of fund managers (some purporting to compete with each other) with large common ownership positions. In any major public corporation, a small number of institutional investors will tend to own a significant portion of the company's shares. This poses a number of new, relatively unaddressed, public policy challenges.

Consider, for example, the tensions that arise between such institutional shareholders and other investors. If one or more institutional investors hold significant positions in both the bidder and the target company in a control contest, they may be indifferent to the price offered for control. If the institutional investors have disproportionately weighted ownership in the bidder, it may favour a lower bid over others available in the market, to the potential detriment of other shareholders in the target company. Should such conflicts of interest be a public policy concern?

Looking beyond the interests of other shareholders (and of capital markets in ensuring that minority shareholders receive fair treatment), consider the potential economic consequences of concentrated "horizontal" ownership. If a small group of institutional owners own dominant stakes in Coca-Cola and Pepsi, they may be relatively indifferent about consumer choice and more concerned about price competition (which diminishes their overall wealth). This was the finding of a recent academic study of the U.S. airline industry, which indicated that routes with high common ownership among carriers have higher ticket prices than routes with low common ownership. The authors cite a former legal counsel of a large asset management firm who suggested that institutional

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investors push companies to focus on profit margins instead of market share in specific markets (presumably, where competition would hurt the interest of the common owners).

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Such conflicts of interest could be harmful to a broader range of stakeholders. It may also help explain other market developments. For example, if common ownership reduces competition, deploying earnings to fund share buy backs becomes more attractive than investing in R&D or capital expenditures (which would force competitors to follow suit, potentially reducing margins). This may disadvantage long-term stakeholders.

Similar conflicts arise from compensation and other internal governance structures. For example, a recent study found a correlation between generous option grants and the incidence of product safety recalls. How often do institutional investors press for the alignment of executive pay with the interests of consumers? How do their own compensation structures align interests with those of beneficiaries?

As "universal owners" large institutional fund managers should be more focussed on managing long-term systemic risks than on the performance of any particular company. This would suggest a fiduciary responsibility of institutional investors to be proactive on issues such as how climate change should be factored into investment decision-making. While a few have taken steps to initiate such culture change, they still tend to be the exception rather than the norm.

Similar effects are evident in capital markets, where the growth of assets controlled by institutional investors has effected significant changes in market structure and trading technologies, including increased volatility arising from the "herding" behaviour of "universal owners," the proliferation of trading venues and the advent of algorithmic and high-frequency trading, all arguably to the detriment of small investors. Regulators are playing "catch up" with these developments, even as institutional investors are beginning to shift away from a focus on timing advantage (over retail investors) in favour of initiatives that allow for larger buy-side to buy-side matches to take place.

With great power comes the responsibility to demonstrate social utility – how the governance and conduct of institutional investors enhances market structures and long-term economic performance and social well-being. For decades, the agenda of capital markets regulators (encouraged by large institutional investors) has focused on corporate governance, including the regulation of conflicts of interest inherent in the corporate structure. The time has come to shift some of that focus "upstairs."

As dominant market actors, large institutional investors have multiple responsibilities – for the stewardship of assets that ultimately belong to others, with a responsibility to society and to help ensure that capital markets function as engines for economic growth.

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