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Remarks at OECD Discussion on Common Ownership by Institutional Investors
Barbara Novick, Vice Chairman

Paris
December 6, 2017

Thank you for inviting us to present our thoughts at today's discussion on common ownership by institutional investors.[1] In addition to my remarks today, we have submitted a white paper titled Index Investing Supports Vibrant Capital Markets.[2]

I am here, not as an "economist", and not as an "anti-trust expert", but rather as a practitioner in asset management. In addition to being Vice Chairman of BlackRock, I am one of the founders of the firm and I am proud to say we are about to celebrate our 30th anniversary.

Asset Managers Act as Fiduciaries for Asset Owners

Let me start with some quick level setting about the role of asset managers, as there is sometimes confusion between asset managers and other financial institutions. We see this confusion in some of the literature on common ownership, which often conflates asset managers and asset owners.

Asset managers do not invest on their own behalf; rather, asset managers operate under an agency business model. For example, while BLK manages $6 trillion, these assets belong to institutions and individuals who are our clients – the "asset owners". Assets owners include pension funds, insurers, sovereign wealth funds (SWFs), and other types of investors.

Asset managers manage thousands of portfolios. Each one is governed by a contract called an "investment management agreement" or an IMA. These IMAs generally specify the investment objective and constraints applicable to the specific portfolio. For example, a large cap equity fund using an index strategy could closely tracking the S&P 500 benchmark, while an international small cap fund actively managed to outperform the MSCI World Small Cap Index would be expected to experience higher tracking error.

Some portfolios are "collective investment vehicles" (CIVs), including US '40 Act mutual funds, Undertakings for Collective Investment in Transferable Securities (UCITs), alternative investment funds (AIFs), etc., while other portfolios are called "separate accounts". The assets held in the latter portfolios belong directly to a specific asset owner and are held at a custodian who is hired by the asset owner.

Importantly, as an asset manager, we charge a fee based on the overall value of the portfolio. Fees on index strategies are often single digit basis points, while active strategies generally command double digit basis point fees. A small subset of portfolios include a performance fee.

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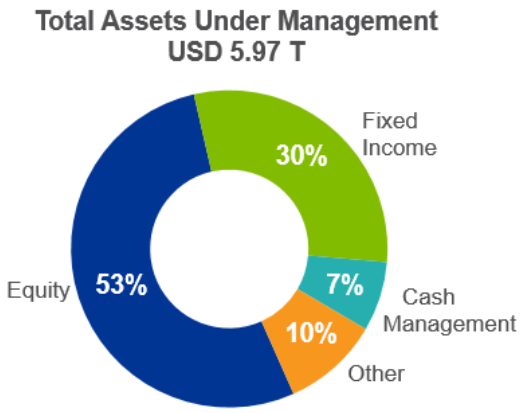
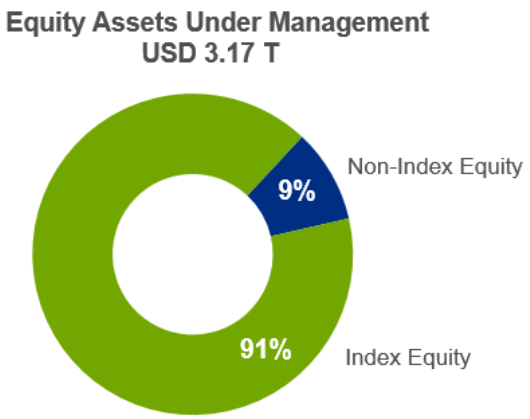
1 OECD Session, Common ownership by institutional investors and its impact on competition (Dec. 6, 2017), available at http://www.oecd.org/daf/competition/common-ownership-and-its-impact-on-competition.htm.

2 BlackRock, *ViewPoint*, Index Investing Supports Vibrant Capital Markets (Oct. 2017), available at https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-index-investing-supports-vibrant-capital-markets-oct-2017.pdf.

Since assets under management (AUM) belong to clients, the investment results belong to the client. For completeness, let me also note that we are regulated at the company level and at the product level by regulators in many jurisdictions around the world.

BlackRock as an Asset Manager





Source, both charts: BlackRock. As of 30 September 2017. Numbers may not add up to 100% due to rounding.

BlackRock's clients include a wide range of institutions and individuals. The left-hand pie shows a simple breakdown of the assets under management by BlackRock on behalf of clients, based on the asset classes that are represented. The right-hand pie breaks down the equity assets to reflect the investment strategy, simply showing index versus other strategies.

Within each of those strategies, there are numerous teams and specific mandates, as well as different investment styles. Today, BlackRock has over 200 equity investment professionals located in New York, San Francisco, Boston, Princeton, Sao Paulo, London, Edinburgh, Tokyo, Hong Kong, Seoul, Shanghai, Sydney, and more.

BlackRock Investment Stewardship

One of the decisions that an asset manager needs to make as a fiduciary on behalf of clients is whether to create a dedicated investment stewardship team or outsource this function to a proxy advisory firm, such as Institutional Shareholder Services (ISS) or Glass Lewis. Many asset managers choose to outsource. As a result, proxy advisory firms are estimated to effectively determine between 10% and 25% of the votes in company meetings, depending on the investor base and company size. Even at the low end estimate, this voting block significantly exceeds the voting power of any index manager. ISS is the dominant player in this market with approximately 80% market share globally.

Over the past decade, many investors have encouraged their managers to vote proxies and engage with companies as part of their fiduciary duty as asset managers. BlackRock has a team of over 30 investment stewardship professionals located in Europe, the Americas and Asia Pacific. We would describe ourselves as actively engaged – which is different from being an activist investor.

Engagement Priorities for 2017-2018

- Governance
- Long-term corporate objectives
- Compensation
- Climate risk disclosure
- Human capital

Proxy Voting Statistics for July 2016 to June 2017

- 17,309 meetings voted
- 10,905 (63%) – BlackRock voted with management recommendations
- 6,404 (37%) – BlackRock voted against, withheld or abstained one or more management proposals
- 5 of 27 (19%) – BlackRock voted in favor of dissident board candidates

Source: BlackRock Investment Stewardship Report: 2017 Voting and Engagement, July 2017.

The left-hand box highlights the types of issues where we engage with companies. Asset managers generally limit their engagement with companies to corporate governance topics such as the qualifications of directors, the time these directors have to devote to their duties, executive pay, or environmental, social or governance (ESG) issues.

Taking the example of governance and board composition, we expect board directors to have expertise and experience relevant to the company's business and long-term strategy, and we engage where we consider board directors fall short of this standard. In terms of compensation, we expect executive pay to reward the effective implementation of the company's long-term strategy and to be aligned with performance over time, and we engage where our analysis suggests the board's policies do not deliver this.

In the paper "Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate", my colleagues Matthew Mallow and Jasmin Sethi expand on the idea of actively engaging with companies on corporate governance issues, which consists of more than simply voting at shareholder meetings.[3]

We aim for transparency in our engagement. We publish our voting guidelines and engagement priorities, we periodically communicate with CEOs and boards via letters that we make public; and we publish our voting record annually and reporting quarterly on our engagement and voting activities. You will notice that discussions on product development or product pricing are absent from this list. Contrary to the hypotheses of some commentators, these types of discussions are *not* part of corporate engagement.

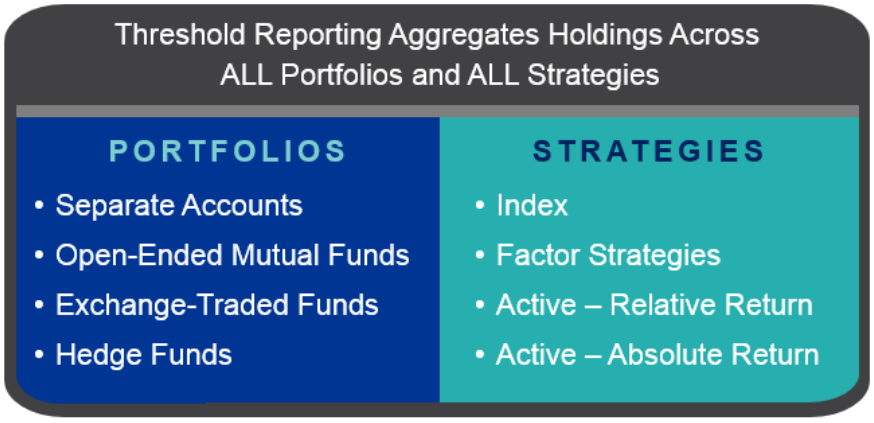
Threshold Reporting

Before we dive into a discussion on threshold reporting, I would like to clarify the difference between cross-ownership and common ownership. Cross-ownership generally refers to the case in which Company A invests in its competitor company, Company B. Common ownership is when a third party, Entity C, holds minority stakes in companies A and B. If the position of the

[3] Matthew J. Mallow and Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck-Strine Debate*, 12 NYU Journal of Law & Business 385 (2016).

third party entity exceeds certain reporting thresholds, this common owner would be subject to disclosure requirements by regulatory regimes around the world.

Threshold reporting is an area of tremendous confusion, in part because these rules are specific to each regulatory jurisdiction. In general, asset managers are required for regulatory reporting purposes to aggregate holdings across all portfolios that they manage. This aggregation can include separate accounts and commingled investment vehicles. This can also include a variety of investment strategies along a continuum from index to active.



To put this in perspective, as of November 17, 2017, BlackRock-managed portfolios held over 46 million shares in Delta. These shares are held across 345 portfolios: 67 are actively managed, and 278 are index strategies tracking 142 individual indexes[4]; 112 are separate accounts, and 233 are commingled investment vehicles.

Importantly, threshold reporting is a regulatory concept. Threshold reporting does not necessarily represent economic ownership. Using the Delta example, when you hear "BlackRock owns 6% of Delta Airlines", this does not mean "BlackRock has a 6% economic interest in Delta". In fact, BlackRock's ownership of Delta is zero. Unfortunately, much of the discussion on common ownership mistakenly implies that the asset manager holds an economic interest in these companies, whereas the beneficial holder is in fact the asset owner.

Berkshire Hathaway Ownership Compared to BlackRock Management

There seems to be some confusion between investment interests of an asset owner versus the management of assets by an asset manager. This slide highlights several important differences between the perceived ownership interests by Berkshire Hathaway and BlackRock.

[4] Number of indexes tracked as of January 17, 2018.

Berkshire Hathaway	BlackRock
• Asset owner with direct ownership of companies.	• Asset manager acting as a fiduciary for clients.
• Holds limited number of companies.	• Holds minority stakes on behalf of clients in thousands of companies.
• Actively chooses companies for investment.	• Index portfolios own stocks according to their respective equity index. • Non-index portfolio holdings vary by mandate.
• Often takes board seats.	• Does not take board seats in public companies.
• Directly impacted by economic results of companies in portfolio.	• Clients bear economic effects and results of companies owned in portfolios. • Asset manager charges a management fee on the portfolio assets under management.

Comparison provided for discussion purposes only to highlight high level differences between asset ownership and asset management. Not meant as a comprehensive comparison or investment advice.

Simply put, Berkshire Hathaway is an asset owner with direct ownership interest in a limited number of companies. Depending on the company, these investments can include minority interests or controlling interests. Someone at Berkshire Hathaway actively decides which companies to invest in, and often their investments include a requirement for a board seat which provides an avenue for potential control. Importantly, Berkshire Hathaway participates in the economic results of each company.

In contrast, BlackRock is an asset manager acting as an agent for clients. Given our business model, our clients collectively hold minority stakes in thousands of public companies and neither we nor they take board seats in any of these companies. In the case of index portfolios, we hold stocks in the same proportions as they are represented in the index. In the case of actively managed portfolios, the holdings vary significantly from portfolio to portfolio based on the investment mandate and the investment style of each portfolio.

Regardless of index or active, BlackRock earns a fee based on the total value of the portfolio, except in rare circumstances. As I mentioned earlier, this fee rate may be single or double digit basis points and is paid regardless of the performance of the underlying investments. Thus, BlackRock does not participate directly in the fortunes of the individual companies in these portfolios, but rather the investment results directly benefit our clients. Consequently, BlackRock has no incentive to discourage competition amongst companies held in various client portfolios.

Asset Managers Lack Incentive to Increase Airline Ticket Prices

In addition to not reaping the benefits of individual stock performance, asset managers clearly lack incentive to raise prices on airline tickets. As this chart shows, US Airlines are components of multiple indexes. Looking across all three of the major airlines, these firms represent less than 1% of any of these indexes. Which, of course, means that companies other than airlines comprise the vast majority of these indexes.

Index	American Airlines	Delta	United	Aggregate
S&P 500	0.09%	0.15%	0.07%	0.31%
MSCI US Large Cap 300	0.12%	0.19%	0.09%	0.40%
FTSE RAFI US 1000	0.03%	0.05%	0.04%	0.12%
FTSE USA	0.03%	0.04%	0.02%	0.08%
MSCI USA	0.03%	0.04%	0.02%	0.08%
Russell 1000	0.09%	0.13%	0.07%	0.28%

Source: Index weightings from S&P, MSCI, FTSE, Russell, retrieved from Aladdin, November 2017.

Further, it is reasonable to assume that many non-airline companies may use airline services. Therefore, even if they were compensated based on the returns of portfolio companies, neither asset managers nor index strategies would have incentives to raise the cost of airline tickets.

Academic Critiques on Early Common Ownership Literature

A group of academics have raised questions regarding the impact of index funds on consumers. These academics claim that common ownership in concentrated industries induces higher prices for consumers, and they go on to suggest policy measures that would limit the diversification of these funds or restrict the voting rights of managers of these funds.

When the first academic papers with theories on common ownership were released, many economists and many people in the industry dismissed them, as the papers purported to show correlations rather than causation. Given our understanding of the agency model of asset management, the rules around threshold reporting, and the diversity of portfolio holdings, there seemed to be little reason to respond directly. As the publicity around these papers increased and policy measures were proposed, more people have taken notice.

Today, there is a growing body of literature challenging the assumptions, methodology and conclusions of the original papers:

TITLE	AUTHOR
The Competitive Effects of Common Ownership: Economic Foundations and Empirical Evidence	Kennedy, O'Brien, Song and Waehrer
The Competitive Effects of Common Ownership: We Know Less Than We Think	O'Brien and Waehrer
Antitrust for Institutional Investors	Rock and Rubinfeld
Testing for Competitive Effects of Common Ownership	Gramlich and Grundl
Executive Compensation under Common Ownership	Kwon
Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry	Dennis, Gerardi, Schenone

In addition to the papers written by Daniel O'Brien and Daniel Rubinfeld, who are here today, let me mention just two of the other papers. The most recent paper was published last month. The authors are Patrick Dennis and Carola Schenone of the University of Virginia along with

Kristopher Gerardi of the Atlanta Fed. The title of the paper is "Common Ownership Does Not have Anti-Competitive Effects in the Airline Industry", which directly contradicts Professor Schmalz's analysis of airlines.[5] As the authors point out, several of the airlines were in bankruptcy during part of the Schmalz study period which accounts for changing control rights during this period.

Likewise, one of the early papers on common ownership suggested that asset managers were somehow responsible for increases in executive compensation. This paper does not even acknowledge the role of compensation consultants who directly advise boards on executive compensation. Dr. Kwon (Associate Research Fellow, Korea Institute of Finance) found that common ownership exerts a strong influence on executive compensation in a positive way in his paper "Executive Compensation under Common Ownership", published late last year.

As I noted at the outset, I am not an economist, and I will let the academics argue the merits of the various papers and methodologies. However, I will note that the academic debate on whether common ownership by asset managers lessens competition is far from settled. Furthermore, any analysis will need to factor in the roles of proxy advisory firms and compensation consultants before any conclusions can be drawn.

Proposed Policy Measures

You have already heard from Einer Elhauge and Dan Rubinfeld regarding the anti-trust considerations. I will focus on the policy measures that have been proposed. These policy measures could be applied to any large asset manager, or for that matter to large asset owners who manage assets internally which would include many large pension plans and sovereign wealth funds. Since so many articles focus on index funds specifically, I will focus my remarks in this section on index funds.

EXAMPLES OF COMMON INDEXES

EMEA	US	APAC
• SIX Swiss Performance Index	• Standard & Poor's (S&P) 500	• Nihon Keizai Shimbun (Nikkei) 225
• Financial Times Stock Exchange (FTSE) All-Share	• Center for Research in Security Prices (CRSP) US Total Market	• Tokyo Stock Price (TOPIX) Index
• Morgan Stanley Capital International (MSCI) Europe	• Standard & Poor's (S&P) MidCap 400	• Hang Seng (HSI)
• Financial Times Stock Exchange (FTSE) 350	• CRSP US Mid Cap	• CSI 300

Source: Morningstar, as of December 2016. The popularity of the equity index is calculated on the basis of the index fund (index mutual funds and ETFs) assets tracking those indexes in each of the three selected regions, in USD.

Index funds are a broad category encompassing dozens of different indexes. You can see some of the more common indexes here. Index providers include S&P Dow Jones, MSCI, FTSE Russell and more. Each provider publishes index inclusion rules, and companies enter and exit the indexes on a regular basis.

Why have index funds become so popular? Three of the most significant drivers of this trend are: (i) the growing awareness of the value proposition that index investment strategies offer in seeking to track, rather than beat, a benchmark index; (ii) increased focus on fees by regulators

[5] José Azar, Martin C. Schmalz, and Isabel Tecu, *Anti-Competitive Effects of Common Ownership* (Mar. 15, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2427345 (Airline Paper).

and investors; and (iii) the shift in financial advice and distribution models towards advisers as portfolio managers.

The holders of index funds include institutions and individuals. Individuals can purchase funds directly, and individuals can hold funds in a defined contribution plan. As a result, millions of individuals across the socio-economic strata are likely to invest some money in index funds.

Limits on Ownership

Some commentators have proposed limiting ownership to 1% of companies' equity, or limiting an institution or clients of a single asset manager to holding one company per sector in a concentrated industry. Whether you restrict a fund to hold no more than 1% of a company's equity, or you limit the fund to a single company in a concentrated industry, you essentially negate the concept of an index fund. This proposed remedy would eliminate diversification within a concentrated industry.

Imagine in 2016 being allowed to hold only one bank. JP Morgan's stock went up by nearly 36% in 2016 whereas Wells Fargo's stock lagged significantly, ending up 4% for the year. Who would decide which stocks an asset manager could hold in which portfolio? Or who would decide how to ration a 1% limit across client portfolios? The harm to investors is obvious.

In addition, companies themselves may be harmed as capital is diverted. Index funds allocate capital to all companies in the index, whereas the proposed ownership limits would directly change capital allocation, potentially leaving many companies without support.

Index Funds Support Long-Termism

A major concern today is the incentives that cause companies to focus on short-term earnings, share buybacks, and the like. While actively-managed portfolios may experience high turnover, index fund investors and index funds themselves are generally long-term holders providing patient capital to thousands of companies.

Longer-term stable capital is a positive for getting companies to focus on longer-term value creation. However, while a manager of an active portfolio can choose to sell the securities of a company that has had poor performance or no longer fits the investment thesis, an index manager holds all of the companies in the relevant index and the manager cannot express its disapproval by selling the companies' stock. As a result, the fiduciary responsibility to engage and vote is more important than ever.

Restrict Voting Rights

Some commentators have proposed restricting an asset manager's ability to vote or engage with companies if they own competitors in a concentrated market. This is directly contradictory to recent efforts by authorities and official sector entities to encourage more active engagement. For example, the OECD has a group focused on corporate governance. In the EU, the Shareholder Rights Directive actively encourages greater asset manager and asset owner engagement with companies on topics including long-term performance and ESG issues. In the UK, asset managers are encouraged to become signatories to the Financial Reporting Council's

UK Stewardship Code. Similar stewardship codes exist in Japan and the Netherlands to which most asset managers have agreed. And, the Investor Stewardship Group (ISG) – which includes both public sector and private sector entities – issued a Stewardship Framework for Institutional Investors and Corporate Governance Principles for US listed companies. At launch, participants in the ISG consisted of a diverse set of investors, including asset owners and asset managers: BlackRock, CalSTRS, the Florida State Board of Administration (SBA), GIC Private Limited (Singapore's Sovereign Wealth Fund), Legal and General Investment Management, MFS Investment Management, MN Netherlands, PGGM, Royal Bank of Canada (Asset Management), State Street Global Advisors, TIAA Investments, T. Rowe Price Associates Inc., ValueAct Capital, Vanguard, Washington State Investment Board, and Wellington Management.

As public authorities are actively debating how to get asset managers to be more vocal on ESG issues, it seems odd to propose restricting corporate engagement or disallowing proxy voting.

Conclusion: Policy Measures are Premature and Harmful

I would like to end with a few key takeaways. First, asset managers lack incentive to reduce competition between companies in a concentrated industry. Common ownership by a single direct investor (e.g., Berkshire Hathaway) is fundamentally different than investing on an agency basis.

Second, as several economists have pointed out, perceived correlations are not the same as causal evidence, and they even question the data and the methodology behind the correlations that have been posited. Even if you discount this and believe there is correlation, there is no compelling causal link between concentration of institutional investors' holdings and industry pricing. And certainly there is no evidence of any link between common ownership and consumer harm.

We should be able to stop here and agree that consideration of policy measures is premature, as there is no clear evidence that a problem exists. However, since policy measures have been proposed, it is important to consider the impacts of these measures. There is broad agreement that index funds provide millions of investors with low cost diversified portfolios as well as providing thousands of companies with long-term patient capital. Furthermore, investment stewardship is being encouraged globally for the recognized benefits these efforts can provide to society. We see no point in harming investors and harming companies or going against the public interest, and since there are already anti-trust remedies in place in many jurisdictions to address collusion and other anticompetitive activity, we do not see a need for new measures.

Taken to their logical extreme, the same arguments would apply to all asset managers, including many pension funds and SWFs that manage assets in-house. For example, Norges Bank owns about 2% in over 500 European companies. Should Norges Bank be subjected to a 1% limit on ownership, or to one company per sector? Or, as an entity that is vocally engaged on ESG issues, should they not be allowed to vote? *Of course not!*

I think it is apparent today that a practitioner perspective is critical to understanding investment strategies and corporate engagement. Likewise, the views of markets regulators who oversee capital markets as well as asset managers and fund products have been noticeably absent from this discussion. As the academic debate around index investing unfolds, it is important to incorporate these views and to factor in the clear benefits index funds provide to investors, to companies, and to society.

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