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January 10, 2019

Mr. Donald S. Clark
Secretary
Federal Trade Commission
Office of the Secretary
600 Pennsylvania Avenue NW
Suite CC-5610 (Annex C)
Washington, DC 20580

RE: *FTC Hearing #8--Competition and Consumer Protection in the 21st Century (Docket ID: FTC-2018-0107)*

Dear Mr. Clark:

Salt Financial[1] appreciates the opportunity to comment on the recent Federal Trade Commission (FTC) Hearing #8 on Competition and Consumer Protection in the 21st century held on December 6, 2018 in conjunction with New York University's School of Law.[2] As a newer entrant to the index-based asset management industry, we welcome the Commission's effort to seek views from a range of market participants on the impact of concentration and common equity ownership on competition.

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[1] Salt Financial LLC is an independent provider of index-based strategies and analytics based in New York. Founded in 2017, the company focuses on using advanced techniques, data, and technology to forecast market risk for use in portfolio construction and risk management tools.

[2] *See* Federal Trade Commission, *Hearing #8: Competition and Consumer Protection in the 21st Century* (December 6, 2018), available at https://www.ftc.gov/news-events/events-calendar/ftc-hearing-8-competition-consumer-protection-21st-century

We focus our comments in three main areas. One is our views on the theories and evidence outlined in the hearing and presented in the papers on the potential for "common ownership" by a concentrated group of large holders to lead to reduced competition within industries and harm consumers via higher pricing. The second addresses some of the broader concerns regarding concentrated ownership on corporate governance, focusing on some of the root causes of the concentration itself, which are potentially anticompetitive. Finally, we suggest some policy options with the potential to diversify ownership and mitigate some of the concerns regarding competition without imposing onerous structural changes that could negatively impact the asset owners themselves—the millions of investors represented by pension plans, mutual funds and ETFs, and other pooled vehicles used to save for retirement, education, and other major life events.

The Case for Common Ownership Suppressing Industry Competition is Weak

Some recent academic papers, primarily using data from the airline and banking industries, suggest that ownership of relatively small, non-controlling stakes in rival firms by large asset managers may be encouraging anticompetitive behavior that potentially harms consumers. In the original airline study, Amar, Schmalz, and Tecu (2016) conclude that airfares are 3-7% higher as a result of common ownership.[3] Azar, Raina, and Schmalz (2016) find a similar effect in the banking industry.[4]Yet Dennis, Gerardi, and Schenone (2017) find no impact of common ownership on airline prices using a similar methodology to Azar, Schmalz, and Tecu. Gramlich and Grundl (2017) use a different methodology to analyze both the airline and banking examples, also concluding no significant impact on either industry.

The studies raise interesting questions and encourage a spirited debate but provide no definitive conclusions. Based on the evidence presented so far, we find the case tying common ownership of small minority stakes in competing businesses to anticompetitive behavior to be weak. For one, the empirical results use a complicated methodology to conclude a causal relationship in the data without sufficiently ruling out other factors. Azar, Schmalz, and Tecu (2016) use a "modified" version of the Herfindahl-Hirschman Index ("HHI"), a standard tool used in the analysis of industry concentration to assess the competitive effects of mergers, to measure both concentration (market share) as well as the degree in which common ownership is likely to induce anticompetitive behavior ("MHHI delta").[5] The authors themselves

[3] José Azar, Martin C. Schmalz, and Isabel Tecu, *Anticompetitive Effects of Common Ownership* (January 30, 2015), available at http://www.utahwfc.org/uploads/2015_10b.pdf. The most recent version of this paper, which has updated figures was published in the Journal of Finance, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/jofi.12698.

[4] José Azar, Sahil Raina, and Martin C. Schmalz¸*Ultimate Ownership and Bank Competition* (January 3, 2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252.

[5] Thomas A. Lambert and Michael E. Sykuta, *The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms*, University of Missouri School of Law Research Paper No. 2018-21 (May 2018) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3173787. The MHHI and the key

acknowledge that the relationships they discovered in their regressions do not prove causality and in fact could be the other way around or may be influenced by other factors not controlled for in the analysis. O'Brien and Waeher (2017) point out that MHHI delta—the key explanatory variable in both the airline and banking studies—is dependent on market shares, which are influenced by the exact same factors driving prices, which will show a correlation between the two even if common ownership had zero effect.[6]

Secondly, no study has presented any plausible explanation on the practical means of exerting influence as a minority, non-controlling shareholder to push rival firms to behave in an anticompetitive manner. As large shareholders, they can participate in corporate governance, but primarily through up/down votes on proposals brought forth by management and the board and without direct participation in these deliberations. As for other means of influence, some studies suggest that shareholders could informally communicate their preferences in private meetings, signal their approval or disapproval through their votes, or withhold approval of executive compensation packages to encourage rival firms to compete less aggressively. However, no study has presented any evidence—even anecdotally—that such tactics are used by large common shareholders to encourage less competitive behavior.

Lastly, the studies fail to acknowledge some aspects of the asset management industry that are important to fully understanding the economic incentives. Echoing the Investment Company Institute ("ICI") in their comment letter to the Commission dated August 20, 2018[7], an investment adviser managing a fund or separate account is typically not the economic owner of the assets—they are simply the agent. These agents—investment advisers—represent the interests of millions of individuals invested in regulated funds by selecting portfolios, managing risk, voting proxies on their behalf where appropriate, and acting as a fiduciary under their obligations under the Investment Advisers Act of 1940.[8] The investment adviser, in representing these interests, must contend with different investment objectives for their investor clients and use a diverse set of investing strategies, including investing in funds managed by investment companies with their own investing mandates. Registered investment companies such as mutual funds and ETFs also must comply with the Investment Company Act of 1940 (among other

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variable MHHI delta, which describes the change in degree of common ownership potentially influencing anticompetitive behavior over time, is complicated to calculate for a given market. For a non-technical description of the methodology, see the appendix in the paper.

[6] Daniel P. O'Brien and Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less Than We Think*, 81 Antitrust Law Journal No. 3 (2017).

[7] *See* Investment Company Institute letter submitted to the Federal Trade Commission "Competition and Consumer Protection in the 21st Century Hearings (Project Number P181201)" (August 20, 2018) *available at* https://www.ftc.gov/system/files/documents/public_comments/2018/08/ftc-2018-0053-d-0018-154975.pdf

[8] Investment advisers must comply with a myriad of regulations, generally covered in the Investment Advisers Act of 1940, including a robust compliance program with written policies and procedures on topics such as proxy voting and the use of material non-public information as well as the establishment of a code of ethics governing conduct, all designed to prevent violations of the Advisers Act and provide a means for regulators to assess compliance.

regulations), which requires an independent board of trustees to oversee the fund and its adviser on behalf of the investor shareholders.

Simply put, the investors, investment advisers, and regulated funds are not a monolith. Layers of differing interests, along with significant regulatory oversight at multiple points, serve to severely diffuse the economic incentive to engage in behavior encouraging firms to be less competitive as a minority, non-controlling shareholder. The structure of the industry does not support the coordinated actions that would make the conclusions from these academic studies plausible.

Broader Concerns from Concentrated Ownership Exist

While the link between common ownership and anticompetitive behavior is less clear, the impact of *concentrated* ownership raises broader questions on corporate governance.[9] John C. Coates of Harvard Law School in his "The Future of Corporate Governance Part I: The Problem of Twelve" (2018) points to the rise of index or "passive" investing, in which a relatively small group of asset managers pursuing index strategies have become among the largest shareholders in nearly all publicly-traded equities in the US, owning anywhere from 20-30%.[10] The largest three indexing firms, Vanguard, State Street, and BlackRock collectively own 15% of the entire S&P 500.[11] Nearly a third of S&P 500 companies have four or fewer shareholders controlling 20% or more of their stock.[12] This concentration, Coates argues, potentially puts control over large swaths of corporate America in the hands of just a few individuals.

Coates does address the potential antitrust concerns espoused by the airline and banking studies but his arguments regarding concentration are much broader in scope.

> *More fundamentally, the rise of indexing presents a sharp, general, political challenge to corporate law…Large companies have always tried to influence the law to protect or extend the power of those in control of those companies, through litigation and other means.*[13]

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[9] "Concentrated" and "common" ownership are separate but related issues pertaining to the control of or influence on a company by minority shareholders. Whereas common ownership refers specifically to large investors owning shares in rival firms, this concern is magnified when held by a relatively small group of large investors. We believe these issues are two sides of the same coin, in that a sharply reduced concentration of shareholders would make it extremely difficult to exercise enough influence to encourage anticompetitive behavior.

[10] John C. Coates, IV, *The Future of Corporate Governance Part I: The Problem of Twelve,* Harvard Law School, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337.

[11] Coates, pg. 13

[12] The "12" as a figure is only representative of a small number relative to the size of US market capitalization and the number of public companies – it does not refer to any specific 12 individuals.

[13] Coates, pg. 13

This view is shared by none other than Jack Bogle, the founder of Vanguard Group, creator of the first index mutual fund, and largest index fund provider in the US. In a recent op-ed in the Wall Street Journal, Mr. Bogle warns that if current trends continue, a small group of large institutional investors will eventually reach voting control of nearly all large US companies and warns that "public policy cannot ignore this growing dominance".[14]

While highlighting the problems, both Professor Coates and Mr. Bogle correctly recognize the challenges in the public policy solutions to address them. Whether the issue is limited to common ownership leading to reduced competition or the broader concerns regarding concentration and control, the proposed remedies are overlapping in purpose—to diversify the ownership among more shareholders and/or impose limits on the control that common/concentrated owners may exert over these companies. However, the proposed solutions presented so far are overly prescriptive, difficult to implement, disruptive and inefficient for investment managers, and likely harmful to the end investor.

We agree with many of the criticisms of these proposals articulated in Mr. Bogle's November 29, 2018 op-ed, namely:

- Mandating that assets from index managers must be carved into separate entities with independent management is highly disruptive and costly.
- Proposals that limit holdings to one company in an industry are impractical (who determines which firms compete?) and make it nearly impossible to simply passively track the performance of a broad index like the S&P 500.
- Additional required disclosures and documentation on governance issues are not harmful in and of themselves, but the process is currently transparent and regulated and large investment managers have already taken steps to provide additional information on their voting policies and procedures.
- Adding a separate advisory board to oversee corporate governance issues for a fund is duplicative and potentially conflicts with the oversight already provided by the fund's board of trustees.
- Proposals to limit the voting power of index investors is difficult to implement and only places more power in the hands of other large institutional shareholders, blunting the impact of any reduction in voting control by a narrow group of large shareholders.

These proposals are impractical to implement and/or questionable in their ability to achieve the desired outcome in terms of limiting control by a group of concentrated shareholders. Speaking directly to the antitrust issue, Lambert and Sykuta (2018) argue that even if there were *some* reduced competition as a result of common ownership, the costs and economic

[14] John C. Bogle, *Bogle Sounds a Warning on Index Funds,* The Wall Street Journal, November 29, 2018.

deadweight loss from the proposed solutions would far outstrip any benefit.[15] But if the general consensus is that concentrated and/or common ownership is either a current problem *or could potentially become a large problem*, what policy options are available that could achieve the objectives while minimizing disruption in the market and preserving the benefits of indexation and professional asset management for investors?

The Index Asset Management Industry is Less Competitive Than It Should Be

The simplest solution to the problem of concentration and related concerns on common ownership is to increase competition in the index-based asset management industry, allowing new entrants to diversify the shareholder base. Currently, just three firms control 81% of index fund assets under management. Vanguard leads with 51% of the market, BlackRock with 21%, and State Street follows with 9%.[16]

Mr. Bogle argues these firms continue to dominate because indexing as a business fails to attract new entrants. He cites two main barriers to entry—large scale and low prices. We believe Mr. Bogle is only partially correct.

"Scale" is often a catch-all term describing the ability of incumbents in a monopoly or oligopoly market structure to maintain their position over time. While it contains many elements of truth, it is often used to mask other structural barriers that are erected to keep competitors at bay. An "economy of scale" is traditionally defined as attaining a position where high upfront costs are recovered and operating costs are continually spread across more units as they are produced, making it more difficult for new entrants to profitably compete. However, in industries with primarily intangible goods and intellectual property, the definition of scale has morphed. Other factors such as "network effects"—the increase in value a service obtains from the addition of more users—have become primary barriers to entry. Brand recognition continues to be a significant asset an incumbent enjoys. These are natural barriers that new entrants must overcome to be successful and are generally healthy to ensure that capital is more efficiently allocated to enterprises that can provide goods and services that consumers need and want. But the traditional practices of colluding to raise price associated with over a century of antitrust enforcement have been replaced with subtler forms of anticompetitive behavior.

Hemphill and Wu (2013) argue that a form of anticompetitive conduct they term "parallel exclusion"—the efforts of multiple firms to block or slow the entry of new firms to a market—is common in industries dominated by a few

[15] Lambert and Sykuta, pg. 2
[16] Bogle, Wall Street Journal, November 29, 2018

large players with negative economic effects that are potentially greater and longer-lasting than traditional collusion focused on pricing.[17]

> *Parallel exclusion deserves much greater attention, for its anticompetitive forms have much greater social consequences than parallel pricing due to their setting a high price leaves the field open to new entrants and may even attract them. In contrast, parallel action that excludes new entrants both facilitates price elevation and can slow innovation. As a source of dynamic inefficiency, it has greater long-term significance for the economy.*[18]

As an example, payment network operators Visa and Mastercard were the first to offer general use credit cards in partnership with member banks that issued the cards back in the 1960s, becoming a "duopoly" with network availability that became ubiquitous. Attempts for others such as American Express and Discover to enter the market in the 1980s and 1990s were stalled not only by the "scale" of the incumbent payment networks but by further efforts by Visa and Mastercard to exert pressure on their member banks. While no formal agreement existed to exclude rivals, the incumbents enacted rules prohibiting member banks from issuing cards on other networks such as American Express in order to continue the right to issue Visa/Mastercard cards. The Department of Justice successfully sued Visa and Mastercard and in 2003 the courts found for the plaintiff, which upheld on appeal.[19] Hemphill and Wu also highlight many other examples of exclusionary activity including "slotting fees" paid to grocery stores for placement on breakfast cereal, the arbitrary setting of standards to prevent PVC-based conduit from replacing metal-based tubing, and agreements between theaters and major studios to limit distribution of independent films.

We believe the small group of index fund providers that currently dominate the market likely engage in some forms of exclusionary conduct to slow or prevent new firms from entering or proliferating, entrenching their positions using tactics like the ones in the case studies highlighted by Hemphill and Wu.[20] True economic scale and aggressively low pricing are factors, but we would argue the impact of these barriers to competition are greatly enhanced by some other structural obstacles that are reinforced by multiple firms within the ecosystem. Specifically, the fast-growing market for exchange-traded funds ("ETFs"), a large subset of the index fund industry, offers signs that the distribution channel for newer products is inhospitable for new issuers, negatively impacting the pace of innovation and exacerbating the

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[17] C. Scott Hemphill and Tim Wu, *Parallel Exclusion*, Yale Law Journal, Vol 122 (2013), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1986407.
[18] Hemphill and Wu, pg. 1185
[19] United States v. Visa U.S.A., Inc., 163 F. Supp. 2d 322, 340–42 (S.D.N.Y. 2001), aff'd, 344 F.3d 229 (2d Cir. 2003), cert. denied, 543 U.S. 811 (2004).
[20] The larger universe of index funds includes index mutual funds, dominated by Vanguard Group. For this section, we limit our analysis to ETFs, which are dominated by the same "Big Three" issuers, only in different order.

concentration of shareholders in many US companies in just a handful of firms.

The ETF Industry is Growing But is Still Dominated by the "Big Three"

Total assets invested in ETFs globally grew from $2.3 trillion in 2013 to over $5 trillion by 2018 with $3.5 trillion in the US alone[21] However, US ETF market share remains very concentrated, with the "Big Three", headed by BlackRock's iShares at 39.3%, Vanguard at 25.8%, and State Street at 17.2% dominating a total of 82.3% of the market.[22] Adding the next two, Invesco and Schwab, brings the top five total share to 91.0%. Five years ago, market share was similarly concentrated among the Big Three with iShares at 38.5%, Vanguard at 20.0%, and State Street at 23.5%--totaling 82.0%. However, in 2013 there were about 50 providers of ETFs in the US compared to over 100 today.[23]

Despite the spectacular growth in the industry, very few new entrants have been able to chip away at the dominance of the Big Three. The stagnation in market share over time itself is not enough to demonstrate any anticompetitive conditions; but the lack of a significant shift in market share does suggest there are other barriers for new entrants to become successful.

The Cost of Launching an ETF has Declined Substantially

Although there are a host of regulatory requirements and start-up expenses involved in setting up and operating an ETF, the costs of entering the business from an operational standpoint are not material barriers to entry. For example, the cost of obtaining approval from the US Securities and Exchange Commission ("SEC") to launch and sell an ETF to the public has declined dramatically, from over several hundred thousand in legal bills alone to a fraction of this total today.[24]

Furthermore, even the largest issuers use a variety of third-party service providers to develop and maintain their ETFs, including large custodial banks to hold the assets, index firms to provide the rules-based strategies, and trading firms that make markets in the funds and facilitate execution with the end investors. Other firms specialize in providing broad fund administration services at an attractive cost for small to mid-sized issuers, either as a white-label arrangement commingled with multiple other issuers in a single "multiple

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[21] Ernst & Young, *Reshaping Around the Investor: Global ETF Research 2017*, available at https://www.ey.com/Publication/vwLUAssets/ey-global-etf-survey-2017/$FILE/ey-global-etf-survey-2017.pdf, BlackRock, *Four Big Trends to Drive ETF Growth, available at* https://www.ishares.com/us/literature/whitepaper/four-big-trends-to-drive-etf-growth-may-2018-en-us.pdf.

[22] Bloomberg, as of December 10, 2018

[23] ETF.com (https://www.etf.com/sections/etf-league-tables/20843-etf-league-table-as-of-dec-31-2013.html, https://www.etf.com/sections/etf-league-tables/etf-league-table-2018-12-04)

[24] All ETF issuers must currently obtain "exemptive relief" from certain provisions of the Investment Company Act of 1940, petitioning to "break the rules" in order to legally list an ETF.

series trust" or on a stand-alone basis. Large or small, ETF issuers are primarily in the business of selecting investment strategies, packaging them into funds, and marketing and distributing them to investors—much of the "heavy lifting" in terms of operations are outsourced to third parties, either for economic or regulatory reasons.[25]

The barriers to entry in terms of upfront costs to enter the ETF business are simply not significant and the gains from scale in terms of operational efficiency are mitigated by competition among fund administrators offering "breakpoint" pricing based on assets in fund accounting, transfer agent, custody, and distributor services. This suggests other factors remain impediments for new entrants to gain a significant foothold in the industry.

The Industry Looks Competitive on Price – But Only for A Few

The ETF industry looks competitive on the surface, with price-leader Vanguard forcing other issuers to match their aggressiveness on management fees for broad, market capitalization weighted indices such as the S&P 500. The overall asset-weighted expense ratio for US ETFs declined from over 30 basis points in 2007 to 21 basis points by the end of 2017.[26] Investors can gain broad market exposure to the S&P 500 for just 4 basis points by investing in the iShares Core S&P 500 ETF (ticker: IVV) or the entire stock market for the same price through Vanguard's Total Stock Market ETF (ticker: VTI).

While Vanguard led the charge on price competition, the other two in the Big Three have been able to effectively compete with both Vanguard and *themselves* by offering slightly different versions of their funds at a lower price point alongside their original higher-priced funds.[27] While investors benefit from the price competition, the Big Three are able to further entrench their positions without other providers stepping in to take market share. The low price is certainly a barrier but is by no means insurmountable as the operational cost is secondary to the true obstacle: distribution.

Distribution is the ability to market funds across the broad universe of retail investors, investment advisers, institutions, and other asset managers. It is the primary challenge for new entrants, which is not uncommon to other

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[25] For example, SEC rules require that firms employ the services of a third party to calculate an index that a fund tracks, even if the index is developed and maintained by the ETF issuer themselves.

[26] Rachel Evans and Carolina Wilson, *How ETFs Became the Market,* Bloomberg, September 13, 2018, available at https://www.bloomberg.com/graphics/2018-growing-etf-market/

[27] Responding to competitive pressure from Vanguard's FTSE Emerging Markets ETF (ticker: VWO) priced at 22 bps (now 14 bps) against the 69 bps of the market leading iShares MSCI Emerging Markets ETF (ticker: EEM), BlackRock introduced the "Core" MSCI Emerging Markets ETF (ticker: IEMG) in 2012, which is slightly different in composition from the index EEM tracks—and priced it at 18 bps (now 14 bps). BlackRock managed to defend its position with $70 billion in its two ETFs ($49 billion for IEMG and $29 billion in EEM) compared to $54 billion for Vanguard's VWO. iShares offered a similar "core" product as a complement to several of its larger, higher-priced funds. State Street is pursuing a similar strategy with its SPDR Portfolio ETFs.

industries. However, there are aspects to the distribution channel in ETFs that are unusual and worthy of further analysis.[28]

"Gatekeepers" Act to Uphold the Status Quo and Reduce Competition

New entrants are limited in the number of customers that can be targeted from day one. Although a new fund can be approved and listed for trading on a public exchange and be made available on self-directed brokers such as TD Ameritrade, Fidelity, or E*Trade almost immediately, there are a series of "platforms" that restrict access for new funds until certain requirements are met. Platforms range from independent broker-dealers, aggregators of investment advisers such as LPL Financial, to regional brokers such as Raymond James, to the big "wirehouse" brokerages (Merrill Lynch, Morgan Stanley, UBS, Wells Fargo).

Determining the suitability or fiduciary standard (broker-dealer versus investment adviser) for a particular investment is a critical function for an investment professional. Performing due diligence on new products is an important part of the process and should be taken seriously. However, the requirements that are placed on many new products often fail to serve any meaningful test of why a fund should or should not be included as an option for a financial professional to potentially use in a client's portfolio. It is important to note that these are not requirements to be placed on a "recommended" list or any other form of preferential placement. For most new funds, brokers or advisers that use many of the platforms are *technologically blocked from purchasing shares of the fund*.

The most common "gates" that new funds face are based on assets under management, liquidity, or time since the fund launched. The asset-based gates range from about $25 million to upwards of $500 million or more per fund. Some are also imposing total firm asset under management minimums

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[28] Looking at some of the recent successes in the ETF industry is informative to understanding what the removal of distribution as an obstacle can do for competition in the industry.

Charles Schwab and JP Morgan are not small companies but were relative latecomers to the ETF industry. Schwab entered the business in 2009 and steadily gathered assets, growing to $17 billion by 2013 and an incredible $119 billion by December 2018. Its advantage is the nearly 11 million brokerage customer accounts that Schwab has built over the years with over $3 trillion in assets providing instant distribution for their proprietary ETFs

JP Morgan also entered the business in 2009 and grew assets to about $6 billion by 2013. But it was not until 2018 when it unlocked its distribution advantage, creating its "BetaBuilders" series tracking foreign countries and regions (Japan, Europe, Canada), boosting its assets from about the same $6 billion in 2017 to nearly $19 billion by December 2018. These products were substantially similar to a number of iShares funds, with assets likely redirected from JP Morgan's substantial asset and wealth management operations a part of their initial push.

These are extreme examples, but evidence of how removing the barriers to distribution can increase competition and diversify the index fund industry. Unfortunately, not every issuer has the account base of a Charles Schwab or the asset management business of JP Morgan. The average new issuer must contend with a series of gates and obstacles that are put up and defended by the incumbents or agents acting on their behalf.

of up to $1 billion or more. In terms of liquidity, many platforms impose a minimum threshold of average daily volume, even though the true capacity for an ETF is governed by the liquidity of the underlying assets and not just the fund itself.[29] Lastly, although the majority of ETFs track rules-based indices that are required to post a current list of holdings every trading day, many platforms impose a mandatory track record requirement of up to 3 years to begin considering a fund. This may have been effective in gauging the consistency in performance of a discretionary portfolio manager but is less so in a transparent, rules-based, index strategy.

The argument to increase competition among ETF providers does not call for the elimination of standards for evaluating funds. There are legitimate reasons as to why a firm may not want its brokers or advisors investing in a particular fund. But the current system of arbitrary guidelines could be more transparent and use more objective tests of diversification, underlying liquidity, and risk to determine whether it could be a potential option for a broker or adviser on their network.

Current practices deprive issuers of a focused group of knowledgeable professionals that can potentially be educated on the merits of a new fund and help innovative strategies grow. One of the most common ways for any investment professional to assess new funds, strategies, and products is to start with a small quantity, either for themselves or for their clients and see how it performs. Banning brokers or advisers from purchasing even 100 shares of a new product removes this feedback loop from the process and imposes unnecessary burdens on newer funds that hurt competition and stifle innovation.

Conflicts Abound Between Large Asset Managers and Large Banks/Brokers

Large asset managers and investment banks have complicated relationships with conflicts of interest that can be challenging to manage. Some of the largest issuers of ETFs, such as BlackRock and Invesco, also manage trillions in more traditional discretionary active funds. The commissions paid just in equities in the US in 2017 was an estimated $8.6 billion, with most from the discretionary active side as opposed to passive/index-based.[30] On the other

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[29] Liquidity in ETFs is ultimately governed by the liquidity of securities underlying the fund (the "primary" market) and not the quotes in the ETF itself (the "secondary" market). For a detailed description of how implied liquidity works see https://www.etf.com/sections/blog/etfs-made-easy-implied-liquidity.[30] Source: Larry Tabb, *Market Data Revenue Analysis for Panel Six: Funding of Core Data Infrastructure*, SEC Market Data Roundtable (October 25-26 2018), available at https://www.sec.gov/comments/4-729/4729-4559257-176198.pdf. The commissions paid by active discretionary funds are typically used to pay for both execution and research services provided by brokers (written reports, data, access to management, and other services), either "bundled" in a higher per-share rate or segregated into execution-only and research portions and allocated to research providers via pooled mechanisms such as commission-sharing agreements (CSAs). Commissions paid by passive index funds are typically for execution-only and tend to be at a much lower per-share rates in comparison to active discretionary funds.

[30] Source: Larry Tabb, *Market Data Revenue Analysis for Panel Six: Funding of Core Data Infrastructure*, SEC Market Data Roundtable (October 25-26 2018), available at https://www.sec.gov/comments/4-729/4729-4559257-

side, the investment banks also happen to own the wirehouses, with armies of their financial advisors serving as key distributors of the funds developed by the large asset managers. Some of the most onerous restrictions on new products are put in place by the same wirehouses that maintain such wide-reaching relationships with the large asset managers.

Many of the same wirehouses have also implemented various "pay to play" programs that require issuers to pay fees just for the right to make a fund available on their platform. The wirehouses are bundling these fees into charges to issuers for mandatory "data fees" that reportedly range from $50,000 to $550,000 per year, depending on the number of funds.[31] These fees make it feasible only for the largest of issuers to participate and represent yet another form of parallel exclusion in the fund business. While there is no explicit objective in using these programs to slow or block competition, it effectively creates yet another daunting hurdle for newer issuers to overcome.

The very existence of the ETF industry, a driver of low cost and increased access for investors since they were first brought to market, weakens the more lucrative traditional model involving high "bundled" commissions received by the banks and brokers and the higher management fees earned by traditional active funds managed by the largest asset managers. There are ample incentives and mechanisms for both the asset managers and brokers to make it as difficult as possible for new issuers to compete with incumbent ETF providers as well as traditional actively managed funds. It is also entirely possible some practices are only inadvertently anticompetitive—by-products of commercial activity undertaken with motives unrelated to competitors.

Anticompetitive Practices Negatively Influence New Issuer Behavior

Any issuer conducting a modicum of due diligence prior to entry understands there are significant distribution challenges in the ETF business. As a result, new issuers make certain choices in terms of pricing, product selection, and marketing plans that would likely be different in a truly competitive environment.

For one, the ETF industry is unusual in that new entrants tend to launch products with prices that are much higher than the incumbents. There were 25 funds launched by 14 new issuers through October 31, 2018, charging an

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176198.pdf. The commissions paid by active discretionary funds are typically used to pay for both execution and research services provided by brokers (written reports, data, access to management, and other services), either "bundled" in a higher per-share rate or segregated into execution-only and research portions and allocated to research providers via pooled mechanisms such as commission-sharing agreements (CSAs). Commissions paid by passive index funds are typically for execution-only and tend to be at a much lower per-share rates in comparison to active discretionary funds.

[31] Sabrina Willmer, *Morgan Stanley Said to Seek Fees From ETF Issuers to Carry Funds,* Bloomberg, January 23, 2017, available at https://www.bloomberg.com/news/articles/2017-01-23/morgan-stanley-said-to-seek-fees-from-etf-issuers-to-carry-funds

average of 58 basis points compared to the asset-weighted industry average of 21 basis points.[32] In many other concentrated industries, the challengers typically use price as a weapon and look to undercut the market leader.

Part of the pricing decision is a realization that it will take much longer to gain access to the platforms—especially the wirehouses—and a higher fee is necessary to compensate for the much smaller pool of potential assets that are initially available to new funds. With a more level playing field in terms of barriers to distribution, new issuers would likely price their products lower, making them more competitive with the larger firms and lowering costs for investors.

The decisions on which products to develop and how to market them are also impacted by reduced competition. While retail investors represent a more open opportunity for newer issuers on day one, the cost of the broad-based advertising required to reach them is often beyond the reach of even well-funded start-ups. With the more tightly focused and educated channel of brokers and advisers largely closed off by asset-based gates and other restrictions, new issuers often gravitate to sensational "themes" in investing in hopes of capturing free exposure from traditional and social media in lieu of incurring traditional advertising expense to vault the fund into prominence and gain assets.[33] "Thematic" products focusing on new technologies or actionable trends can be useful components in an investor's portfolio. But the less competitive nature of the industry is likely leading more issuers to focus on narrower and narrower themes in hopes of hitting the "ETF lottery" with an explosive launch out of the gate. The road for more diversified, less flashy investment products is harder, which is affecting the decisions made by new issuers and likely stifling innovation in the process.

Not All Index Strategies are Passive – And That's a Good Thing

"Passive" and "active" are broad labels that are over-used in describing styles of investing in the asset management industry. While a fund that tracks a broad, market capitalization weighted index such as the S&P 500 would meet most definitions of a truly "passive" investment, there are many transparent, rules-based, index strategies that fall somewhere between discretionary "active" and purely passive strategies. Whether they are called "smart beta", "factor investing", "strategic beta", or simply "quantitative", rules-based investment strategies are among the fastest growing categories in the

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[32] Lara Crigger, *New ETF Kids On The Block,* ETF.com, November 27, 2018, available at https://www.etf.com/publications/etfr/new-etf-kids-block?nopaging=1 and Bloomberg for the all-US averages as of December 10, 2018.

[33] Tom Lydon, *Another Blockchain ETF Tops $100 Million in AUM* ETFTrends.com, February 1, 2018, available at https://www.etftrends.com/another-blockchain-etf-tops-100-million-in-aum/2/?utm_source=Pagination&utm_medium=pagination&utm_campaign=pagination

industry.[34] Since they depart from the securities selected and/or weighting of broad market indices, they are making active bets on certain characteristics of stocks (and now bonds) using various quantitative screens and measures.

As of December 2018, there were $776 billion in ETF assets classified as "smart beta" by Bloomberg—23% of the total and up from $320 billion in 2013[35] Much like the broad market trackers, smart beta/factor ETFs are dominated by just a handful of providers. iShares or Vanguard lead in every category listed with Invesco taking third place, replacing State Street.[36] They also present the same obstacles for new providers, with assets under management gates, pay for play arrangements, and undesirable conflicts that exist between incumbent providers and brokers.

Unlike purely passive index trackers, there are significant opportunities for new rules-based, quantitative strategies that can leverage new technologies such as machine learning, harness alternative data, and apply insights from a wider group of individuals in the market. By limiting competition through the obstruction of the distribution channel, the pace of innovation is slowed, leading to losses in economic welfare and investor choice.

Although Mr. Bogle is probably correct that the purely passive index business will not likely attract enough competitors due to the scale attained by the Big Three and the ultra-low fees currently charged, we believe there is sufficient opportunity in more "active" index-based strategies that can begin to chip away at some of the concentrated ownership in US stocks.

Simple Policy Options to Encourage Competition and Reduce Concentration

Increasing competition among indexers could have far-reaching benefits that address some of the concerns regarding concentrated and common ownership of US stocks while helping investors with more innovative diversified index strategies at lower prices. Fortunately, there are some relatively simple policy suggestions that can advance this objective without overly burdensome regulations or implementation difficulties.

1. *Generic Fund Standards*

   To help increase access to new products that are less complicated, diversified, and composed of liquid underlying holdings, we propose a

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[34] Andrew Ang, *Factors Making Waves,* June 5, 2018 available at https://www.blackrock.com/investing/investment-ideas/what-is-factor-investing/factor-commentary/andrews-angle/factor-growth

[35] Bloomberg, December 10, 2018

[36] Invesco—through its subsidiary Powershares that it acquired in 2006—was an early mover in "smart beta" investing products in the early 2000s, although its $60 billion flagship Nasdaq 100 Trust (QQQ) remains the anchor of the legacy Powershares lineup. Invesco has since acquired ETF providers Guggenheim and the fund arm of Oppenheimer to increase its heft in the industry.

more transparent, objective, and standardized set of criteria that could be used to determine whether a new ETF is included on a platform. The current system is arbitrary, riddled with conflicts, and favors the largest incumbent providers.

The generic listings standards adopted by the three ETF listing exchanges in the US (NYSE Arca, Cboe, and Nasdaq) serve as a potential model for more objective platform access criteria. Qualifying for "generic" listing of an ETF on an exchange streamlines the process for new funds to come to market, avoiding the filing of an application with the SEC under Rule 19b-4, a potentially costly and lengthy process.

The three exchanges have very similar but not identical criteria for generic listing that generally reflect the following requirements for US equity ETFs, which apply to both index-based and active products[37]:

- Component stocks that compose 90% of the portfolio must be $75 million in market capitalization or greater;
- Component stocks accounting for 70% (and up to 90%) of the portfolio must have minimum monthly trading volume of at least 250,000 shares in past six months or minimum notional value traded per month of $25 million over the past six months;
- The heaviest weighted component must not exceed 25% (30% for some) of the weight of the portfolio and the five heaviest weighted components must not exceed 65% of the total;
- There must be at least 13 component stocks;
- All components must be listed on an exchange; and
- American depositary receipts (ADRs) are excluded (or limited to no more than 10% of the portfolio for actively managed ETFs).

There are similar standards established for ETFs with non-US components and fixed income securities.

Should an ETF meet these requirements, the issuer can apply for exchange listing without additional approvals required from the SEC to begin listing and trading. These standards are intended to provide an easier path for funds that are sufficiently diversified and made up of liquid, exchange-traded components of sufficient size.

Criteria for ETFs under the generic listing standards can be modified and used to define a "generic" fund that qualifies for open access on all ETF distribution platforms, including independent broker-dealers, aggregators, and wirehouses. It may be prudent to adjust the levels of

[37] For a summary of generic listing standards, see the ICI guide "Understanding the Regulation of Exchange-Traded Funds Under the Securities Exchange Act of 1934", available at https://www.ici.org/pdf/ppr_17_etf_listing_standards.pdf, page 7.

diversification, size, or liquidity required to be slightly more restrictive for platform access in comparison to exchange listing, but not to the point of effectively excluding the vast majority of new funds.

In addition to promoting more competition in the industry, a generic fund standard would free up resources on the committees that review new products at the platform operators, allocating more time to oversee specialized products that do not meet the generic standards and are worthy of closer scrutiny.

2. *Limits on "Pay to Play"*

The ability to charge for access to a platform should be limited to access to a preferred provider designation, inclusion on a non-transaction fee program, or other commercial arrangement that involves a "step up" in product placement analogous to compensating the store owner for an eye-level slot on the shelf. "Pay for play" schemes should not be permitted for simply allowing the fund to be purchased by a broker or adviser on the platform after doing their own due diligence.

This must also be effective in practice and not in name only. Some wealth management platforms prevent their financial advisers from purchasing some products for their fee-based accounts but allow them in brokerage (commission-based) accounts, which represents a shrinking percentage of their overall business. If the fund meets the generic standards, it should be available across the platform, regardless of compensation structure (fee vs. commission) used.

Furthermore, the mandatory purchase of data as a condition for access to the platform should be prohibited. If the data is valuable, there should be no issue in making it commercially available for a fee without the tie-in to simple access to the distribution channel.

Adopting standards for more open access and a limitation on pay for play does not preclude firms from maintaining recommended lists, model portfolios, or other general recommendations or policies for their brokers and advisers. This proposal is not suggested as a replacement for due diligence on new products. It just streamlines the evaluation of the basic characteristics of a fund by eliminating the arbitrary criteria and "guidelines" that can contribute to the entrenchment of incumbent firms at the expense of new entrants.

In light of the benefits of broader diversification of ownership of US stocks and the anticompetitive practices in the index fund industry slowing the entry of firms that can alleviate this condition, we urge the Commission to consider exploring actions that could encourage more competition in index funds and ETFs. We believe industry-led adoption of generic fund standards and limitations on the ability for pay for play schemes to outright block availability of funds on distribution platforms should be the preferred remedy with the least cost and complexity. Absent these actions, we encourage the Commission to analyze additional data and explore other remedies to increase the competitiveness of index-based asset management.

We appreciate the opportunity to comment on the common and concentrated ownership debate and provide our perspective on the causes that we believe to be rooted in anticompetitive conduct at a level one step below. Should you have any questions on our comments, please feel free to contact me directly at 646-779-1051 or tony@saltfinancial.com.

Sincerely,

/s/ Anthony R. Barchetto

Anthony R. Barchetto, CFA
Founder and Chief Investment Officer

cc: The Honorable Joseph J. Simons
The Honorable Maureen K. Ohlhausen
The Honorable Noah Joshua Phillips
The Honorable Rohit Chopra
The Honorable Rebecca Kelly Slaughter
Mr. Bruce Hoffman, Director, Bureau of Competition
Mr. Bilal Sayyed, Director, Office of Policy Planning