PROMOTING ECONOMIC GROWTH: A REVIEW OF PROPOSALS TO STRENGTHEN THE RIGHTS AND PROTECTIONS OF WORKERS

HEARING

BEFORE THE

SUBCOMMITTEE ON INVESTOR PROTECTION, ENTREPRENEURSHIP, AND CAPITAL MARKETS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

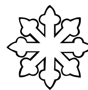
ONE HUNDRED SIXTEENTH CONGRESS

FIRST SESSION

MAY 15, 2019

Printed for the use of the Committee on Financial Services

Serial No. 116–24



U.S. GOVERNMENT PUBLISHING OFFICE

37–926 PDF WASHINGTON : 2020

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PROMOTING ECONOMIC GROWTH: A REVIEW OF PROPOSALS TO STRENGTHEN THE RIGHTS AND PROTECTIONS OF WORKERS

Wednesday, May 15, 2019

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:01 a.m., in room 2128, Rayburn House Office Building, Hon. Carolyn Maloney [chairwoman of the subcommittee] presiding.

Members present: Representatives Maloney, Sherman, Scott, Foster, Vargas, Gottheimer, Gonzalez, Porter, Axne, Casten, Ocasio-Cortez; Duffy, Stivers, Wagner, Hill, Emmer, Mooney, Davidson, and Hollingsworth,

Ex officio present: Representatives Waters and McHenry.

Also present: Representatives Garcia of Illinois and Phillips.

Chairwoman MALONEY. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will come to order. And without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee are authorized to participate in today's hearing.

Today's hearing is entitled, "Promoting Economic Growth: A Review of Proposals to Strengthen the Rights and Protections of Workers."

I now recognize myself for 3 minutes to give an opening statement.

We spend a lot of time in this subcommittee talking about the relationship between companies and their investors. But the relationship between companies and their employees is just as important to the economy.

Public companies have hundreds of thousands of employees, and almost all of the largest companies in the country are public companies, so the policies they have for employees and the wages they pay set the tone for the rest of the economy.

This hearing will examine four bills on public company workers. Two of the bills we will be discussing today come from Congresswoman Cindy Axne.

The first bill is the Outsourcing Accountability Act, which would require companies to disclose in their annual report the total number of employees they employ in each State and each foreign country. The bill also requires companies to disclose how those numbers have changed from the previous year, which is critically important because it will allow investors and the public to monitor which companies are sending U.S. jobs overseas and also to see which companies are bringing jobs back to the United States.

The second bill from Congresswoman Axne would require companies to disclose much more information to investors about their human capital management policies. Companies often say that their employees are their most valuable asset. And if that is true, then information about the makeup of the company's workforce is of paramount importance to investors.

For example, investors need information about overall workforce skills and capabilities in order to know whether the company has the capacity to take on projects that require a very specialized skill set.

Congresswoman Axne's bill would require companies to disclose this kind of information, which is critically important in today's modern economy.

Next, we have a bill that would require the SEC to conduct a study on stock buybacks. I think this is an incredibly important issue, and I certainly hope that this isn't the last bill we take up on stock buybacks.

U.S. companies spent up to 60 percent of the tax cuts they received in the Republican tax bill on stock buybacks. They could have used that money to raise their workers' wages or to invest in new equipment or in research and development. But instead they used it to buy back their own stock, thereby enriching their own executives.

The bill we are examining today would require the SEC to study how buybacks can be misused to benefit executives and the impact that buybacks have on employee wages.

Finally, we have a bill from Congressman Phillips which would require companies to disclose how much of a pay raise it is giving to executives every year and compare that with the pay raise it gave to its median employees.

I look forward to hearing from all of our witnesses on these important bills.

And with that, the Chair recognizes Mr. Hollingsworth for 4 minutes for an opening statement.

Mr. HOLLINGSWORTH. I am going to read Mr. Huizenga's—who is out ill—opening remarks for this subcommittee hearing:

"America's robust capital markets are key to our long-term economic growth. Businesses of all sizes depend on our capital markets to access financing to get off the ground initially, sustain operations, manage cash, make payroll, and even create more jobs.

"Although our capital formation framework is better than it was a decade ago, it is troubling that many of today's rules and regulations have discouraged companies from going public.

"Unfortunately, the U.S. continues to witness a downward spiral in the number of new businesses being created, which in 2016 hit a 40-year low. The U.S. has only seen half the number of domestic

IPOs that it did 20 years ago, while the U.S. has doubled the regulatory compliance costs a business must undertake.

"With more companies opting for private fundraising rather than the public market, the number of public companies has decreased to levels not seen since the 1980s. In fact, 20 years ago, American investors could pick from over 7,000 listed stocks. Today, that number stands at merely 3,500.

"This means that everyday investors or Main Street, such as John and Jane 401(k), are missing out on valuable opportunities to invest in the next Microsoft, the next Amazon, or the next Google.

"IPOs have historically been one of the most meaningful steps in the lifecycle of a company. Going public, as it is termed, was the ultimate goal for entrepreneurs. You start a business from scratch, you build it into a successful enterprise, and then open up the opportunity for the public to share in your success.

"Going public not only affords companies many benefits, including access to the public markets, but IPOs are an important part of the investing public. By completing an IPO, a company is able to raise much needed capital for job creation and expansion opportunities, while allowing Main Street investors the opportunity to have an economic piece of the action and the ability to participate in the growth phase of a company.

"For myriad reasons, the public model is no longer viewed as an attractive means of raising capital. Companies are drowning in a sea of regulatory red tape and increasing compliance costs created by Washington bureaucrats.

"This is truly troubling. Instead of constructing arbitrary laws that cut off access to our capital markets, Congress should be working to create an atmosphere that helps promote more capital formation, to allow the free flow of capital, strengthen job creation, and increase economic growth.

"However, the four draft legislative proposals that we are examining today do very little to promote economic growth. Instead, these bills will do nothing but impede economic growth. By mandating the additional disclosure requirements, it will only increase compliance costs for companies, and take away precious resources that could have been used to hire more workers, increase wages, and grow these companies.

"Instead of working to protect investors and helping to facilitate capital formation, these proposals will be more focused on exerting societal pressure on public companies by demanding meaningless information that is not material to investors making investment decisions.

"The increased costs for complying with these hollow disclosures will only stifle growth and discourage more companies from going public, ultimately hurting American workers and mainstream investors."

And with that, I yield back.

Chairwoman MALONEY. Thank you.

The Chair now recognizes the gentlelady from Iowa, Mrs. Axne, for 1 minute.

Mrs. AXNE. Thank you, Chairwoman Maloney. And I also want to thank all of the witnesses for being here. I am so happy that

we are having this hearing today to promote long-term economic growth, and the two bills I am sponsoring will help with that.

The first is the Outsourcing Accountability Act, which requires that public companies disclose in their annual report the number of employees they have in each State or country.

I was personally surprised when my staff told me that companies don't report this data, and having this information would help consumers and investors make decisions to support companies that help build American jobs.

My other bill we are discussing today would increase disclosure about human capital management practices at companies, including workforce safety, compensation, and skills training programs.

This subject is very important to me, since I was hired by the Chicago Tribune now almost 20 years ago as a human capital manager. So I know companies have been working on this for a long time and have invested in human capital management. And better disclosure of these practices will help us focus on long-term growth of companies and the American economy.

Thank you. And I yield back.

Chairwoman MALONEY. The Chair now recognizes the ranking member of the full Financial Services Committee, Mr. McHenry, for 1 minute.

Mr. MCHENRY. Thank you. I appreciate the Chair yielding.

The American economy is strong. We had an unexpectedly high economic growth rate for the first quarter with 3.2 percent. Job creation was 263,000 new jobs created last month. Unemployment was at its lowest level in more than 50 years, and wage growth has increased to over 3 percent year over year. This is a significant thing. In short, the American economy is strong.

And yet, we know not everything is perfect. We know that there are fewer stock listings for average everyday investors to be able to participate in. That is a problem. It has halved over the last 20 years. That is significant.

And what we should be talking about as a committee is how we encourage more public offerings so that average everyday investors and pensioners can hold those assets and benefit from a rising economy. How can we link that greater economic growth to individual gains in our society? That should be our conversation, rather than the social engineering and government mandates that we are currently discussing in this hearing.

And I fear that by imposing these mandates we will actually have fewer public offerings and less encouragement to participate in the public markets.

And so I hope we can work together to achieve some bipartisan results, but we need to focus on what is really important, not social experimentation.

Chairwoman MALONEY. Thank you.

I now recognize the gentleman from California, Mr. Sherman, for 1 minute.

Mr. SHERMAN. The Republicans have pointed out that sometimes we load up burdens on publicly traded companies and maybe that discourages companies from going public. And I will agree.

That is why all the requirements we are talking about now should apply to public companies and private companies and any

company that has expenses or revenues of over $100 million in the United States, because these companies play an important role in our economy. And if you are a median worker not being paid enough, that should matter to you, whether your company is held by private equity or whether it is publicly traded.

So we need information for our society from all of the major companies. And I look forward to realizing—we are not the SEC where our powers might be limited to publicly traded companies. We are the United States Congress, and we ought to have legislation that applies to all major companies, no matter how they are owned.

I yield back.

Chairwoman MALONEY. Today, we welcome the testimony of a very, very distinguished panel of witnesses.

First, we have Steven Clifford, who is the author of, "The CEO Pay Machine," and served as the CEO of King Broadcasting Company from 1987 to 1992, and as CEO of National Mobile Television from 1992 to 2000.

Second, we have Heather Slavkin Corzo, who is the director of capital markets policy for the AFL-CIO, and is a senior fellow at Americans for Financial Reform.

Third, we have Dr. Abigail Disney, who is the president of Fork Films, and is the chairperson and co-founder of Level Forward, which is located in the district I am privileged to represent.

Fourth, we have Nili Gilbert, who is the co-founder and portfolio manager at Matarin Capital Management, which is also located in the district I am privileged to represent.

And last, but not least, we have James Copland, who is a senior fellow at the Manhattan Institute, where he serves as the director of legal policy.

Witnesses are reminded that your oral testimony will be limited to 5 minutes. And without objection, your written statements will be made a part of the record.

Mr. Clifford, you are now recognized for 5 minutes to give an oral presentation of your testimony.

Thank you.

STATEMENT OF STEVEN CLIFFORD, AUTHOR, AND FORMER CEO OF KING BROADCASTING COMPANY

Mr. CLIFFORD. Thank you.

I have served on over a dozen corporate boards and chaired the compensation committee for both public and private companies. In that role, I got to see how CEOs are actually paid. I got to look at the pay system that is used in all large companies today for CEOs.

As I saw it at work, I said, "This is crazy." It overpays the CEO. That is a small problem. A much bigger problem was the impact on morale. And the worst problem was it created reverse incentives and pushed everybody towards short-term metrics.

So to convince my fellow board members to fire our very expensive consultants, I began to do some research and I concluded that it does hurt the companies that use it. It also impedes economic growth, and it is a principal driver of the rising income inequality.

Now, let me state that I believe in free market capitalism. I think with a light regulatory touch, this is the best economic sys-

tem known to man. I criticize CEO pay because it has nothing to do with free markets and it hinders a robust capital company.

First of all, it has nothing to do with supply and demand. Now, a market sets the rate for supply—supply and demand sets a rate for athletes and movie stars. Teams and studios bid for their services because their services are portable. LeBron James is going to improve any basketball team he joins. Meryl Streep is going to improve any movie she is in.

Most CEOs would not improve another company, because their competence rests largely on the knowledge of a single company, its finances, products, personnel, culture, et cetera, et cetera. This is very necessary to run that company, but it is not worth much outside that company.

That is why three-quarters of all new CEOs—and I am talking about S&P 500 CEOs—are internal promotions. Companies rarely bid for an outside CEO. Less than 2 percent of all of these CEOs were previously the CEO of another public company. CEO jumps between these companies happens less than once a year, and when they jump, they usually fail and are twice as likely to be fired than internal promotions.

So with no auction market to guide them, these firms and consultants have put together a rigged, corrupted system, a totally administered system of how to calculate CEO pay. It is a very complicated system. I will explain it later if you want.

But basically what they did was they started a game of CEO leapfrog, and CEOs just keep leaping over each other every year in pay. That has increased CEO pay by 1,000 percent since 1980. At the same time, the average workingman has virtually nothing.

Now, the system doesn't pay for performance. Studies have consistently shown that CEO pay and CEO performance are uncorrelated or even negatively correlated. It doesn't align them with shareholders and it is not needed to motivate CEOs. CEOs are the most motivated people you have ever met to start with.

Perversely, this system channels that motivation, not towards long-term growth, but towards short-term financial metrics that will earn a bonus.

For example, the average CEO serves only 4.7 years and gets 85 percent of his compensation in equity, which gives him a compelling reason to have a high stock price.

There are two ways of getting this. One is to actually beat the competition with better products at lower prices. The easier way is to buy your own stock. As you mentioned, the S&P 500 spent $800 billion last year buying back stock. Since 2016, those companies have not reinvested a penny. It has all gone towards buybacks and dividends.

The greatest damage falls not on those companies, but on the company itself. As I said, it is one of the principal drivers of the increase in income inequality.

So here you have a system that enriches only the insiders who manage it: the consultants; the board; and the top executives. They are not going to change it. Shareholder "say-on-pay" votes have ignored that you have a structural problem here: that the system used to pay them is rigged. And they only vote against 1 percent of the most outrageous packages.

So when self-serving CEOs and corporate directors neglect their fiduciary duty, to the detriment of almost everybody else, I think it is time for government to exercise regulatory oversight, and so I support the legislation we are considering today.

[The prepared statement of Mr. Clifford can be found on page 44 of the appendix.]

Chairwoman MALONEY. Ms. Corzo, you are now recognized for 5 minutes.

STATEMENT OF HEATHER SLAVKIN CORZO, J.D., DIRECTOR OF CAPITAL MARKETS POLICY, AFL-CIO; AND SENIOR FELLOW, AMERICANS FOR FINANCIAL REFORM (AFR)

Ms. CORZO. Thank you. Chairwoman Maloney, Mr. Hollingsworth, and members of the subcommittee, thank you for inviting me to testify.

The AFL-CIO and AFR work on behalf of millions of people to promote policies that create a safe, sound, and stable economy that helps all Americans achieve economic security.

My work, to a large extent, focuses on policies to protect and grow the $7 trillion invested in collectively bargained retirement plans.

Today, the subcommittee will consider a number of proposals aimed at promoting economic growth by strengthening workers' rights and protections in the capital markets. I commend the subcommittee for taking up these critical issues.

Investors increasingly acknowledge that human capital management (HCM) is a material financial factor that responsible investors must incorporate into investment decisions. HCM refers to a set of practices and strategies for how a company recruits, manages, and develops its workforce.

Executives always say that their workforce is their greatest asset, yet rarely offer information on how that asset is maintained, cultivated, or grown, or what labor costs are comprised of, or how they are managed.

Policy changes are needed to update disclosure requirements to require robust human capital management disclosures. The legislation being considered today would go a long way toward addressing the current lack of information available to investors.

Buybacks. In recent decades, companies have spent exorbitant sums of money buying back their own stock. The 2017 Tax Cuts and Jobs Act hypercharged this practice. In 2018, companies spent more than $1 trillion buying back their own stock and are on pace to surpass that level in 2019.

At the same time, the portion of corporate earnings used to pay workers is near all-time lows for the modern era. Excessive spending on buybacks has prompted concerns that companies are prioritizing short-term stock price jumps over long-term investments.

Executives whose compensation is primarily comprised of stock-based awards gain the most from short-term maneuvers to boost stock prices. Workers and long-term investment in business improvements suffer.

Congress must pass legislation to rein in stock buybacks.

I would also like to address two topics not on the agenda for today's hearing where policies from this subcommittee could substantially improve economic security for American workers.

The first is worker representation on boards. The single most effective way to improve workers' rights and address income inequality is to empower workers to command better wages, benefits, and working conditions.

In the corporate governance context, this means ensuring worker representation on corporate boards. In many advanced economies with highly competitive private sectors, worker representation on boards has been the norm for decades. This must be part of a broader conversation about how we incorporate stakeholder interests into corporate decisions.

And, finally, private equity. Working people are exposed to private equity as employees, investors, and participants in the American economy. Private equity-owned companies employ 11.3 million American workers.

When the companies fail, these workers often lose their jobs, benefits, and retirement plans. Toys "R" Us, Topps, Haagen, and Caesars are examples that left tens of thousands of workers unemployed. Sears, owned by a hedge fund that used private equity style strategies, is yet another example.

At the same time, U.S. pension funds collectively have more than $800 billion invested in private equity. Unfortunately, the exorbitant fees that go along with this investment do more to enrich the already extremely wealthy general partners than they do to provide for the retirement security of pensioners.

Finally, regulators in the U.S. and around the world have begun raising alarms that the outstanding risky loans used to finance LBOs could create systemic risks.

The private equity model exists and is remarkably profitable due to a series of loopholes and carve-outs in securities, bankruptcy, and tax law. There is no public interest reason to provide these. In fact, I would argue that the public interest demands that policymakers eliminate legal and regulatory privileges that feed abusive leveraged buyouts (LBOs).

I encourage the committee to consider these issues.

In conclusion, the best way for investors to do well is to invest in a stable, sustainable, and growing economy. Sound economic growth requires employers to invest in workers and workforce development, to provide family-sustaining compensation packages so that our consumer-driven economy can drive, and to devote resources to strategies that give their enterprises the chance to prosper in the future.

Thank you, and I look forward to your questions.

[The prepared statement of Ms. Corzo can be found on page 77 of the appendix.]

Chairwoman MALONEY. Dr. Disney, you are now recognized for 5 minutes.

STATEMENT OF ABIGAIL E. DISNEY, PH.D., PRESIDENT OF FORK FILMS, AND CHAIR AND CO-FOUNDER OF LEVEL FORWARD

Ms. DISNEY. Thank you. Thank you, Chairwoman Maloney, Ranking Member Hollingsworth, and members of the subcommittee.

I am a filmmaker, an activist, and the granddaughter of Roy O. Disney, who co-founded the Walt Disney Company with his brother. I have no role at the company, nor do I want one, and I hold no personal animus to anyone there. And I do not speak for my family, but for myself.

But today I hope to raise some simple questions about CEO compensation. Does a CEO's pay have any relationship to what his hotel maids and janitors get? Do the people who spend a lifetime at the lowest edge of the wage spectrum deserve what they get, or does any full-time worker deserve the dignity of a living wage?

Disney is not just any company. It is not U.S. Steel or Proctor & Gamble or any other iconic American brand. The Disney brand is an emotional one, a moral one. I would even say it is a brand that suggests love.

I have spoken up as a Disney about Disney, because I am uniquely placed to do so and because Disney is uniquely placed in American life. Those moral undertones and all of that love need to be put to constructive use, because this is a moral issue.

Bob Iger is a nice man, a brilliant manager, and so are most CEOs. But corporate excess has become so normalized that they and their peers can't really see the problem anymore.

It is hard to worry about a problem that builds slowly, but the corporate emperor is wearing no clothes. In fact, he has been doing a long, slow striptease since the 1980s.

There is nothing inherently wrong with a $65 million payday, as long as your own employees, people my parents and grandparents taught me to love and revere, are not so strapped for money that they have to ration their insulin.

Offering education is nice, but what they might earn someday in the future has nothing to do with what they earned working all day today.

These are not the values my family taught me.

This company could lead, if it so chose. Disney led when it offered benefits to same-sex partners; it led when it prioritized the environment. Disney could lead once more. All it lacks, ironically enough, is the imagination to do so.

The burden is not just on Disney, and Disney is a long way from being the worst offender. But for the time being, let's just focus on what Disney could do.

Disney could tomorrow raise the salaries of all of its workers to a living wage, and nothing about doing so would constrain any capital market anywhere. Disney could take half of this year's enormous bonuses and put them into a dedicated trust fund that would help with employees' emergencies. It could offer stock options to all employees and not just to people at the top. It could hold two or three seats on the board for employee representatives. After all, when your board is filled with people who are or want to be CEOs, you are unlikely to get a lot of pushback about your bonus.

I sincerely hope you will pass the human capital disclosure bill, but I humbly want to suggest one change to it. Many people focus on Robert Iger's 1,432 times pay ratio, which is outrageous indeed, but this is a wildly imperfect measure. That ratio doesn't reflect the fact that in some sectors, median workers' pay is higher than in others.

That means that a banker is not getting called on the carpet for his compensation even though he is just as guilty of driving his own workers' wages down while walking away year after year with millions.

We need to measure the CEO's ratio to the salary of his lowest full-time worker. Why on Earth do we currently behave as though one's fate has nothing to do with the others'. Low-wage workers' lives are rendered invisible by the current measure, and that has made it too easy to assume that their lives have nothing to do with management's. We have chased vast swaths of Americans into a box canyon and then blamed them for being trapped.

Philanthropy is often offered as an answer to the problem, but this is not a question of individual decisions. We are talking about the consequences of structures that create and enforce deeply unfair and inequitable social structures. We need to change the way we understand and practice capitalism.

Yes, managers have a fiduciary obligation to their shareholders, but they also have a legal and moral responsibility to deliver returns to shareholders without trampling on the dignity and rights of employees and other stakeholders. It was possible to do this when my great uncle and grandfather built the company, and it is possible now. People made this problem, and by people it can be fixed.

Thank you.

[The prepared statement of Dr. Disney can be found on page 92 of the appendix.]

Chairwoman MALONEY. Ms. Gilbert, you are now recognized for 5 minutes.

STATEMENT OF NILI GILBERT, CO-FOUNDER AND PORTFOLIO MANAGER, MATARIN CAPITAL MANAGEMENT

Ms. GILBERT. Good morning, and thank you, Chairwoman Maloney, Ranking Member Hollingsworth, and members of the subcommittee, for inviting me to testify.

My name is Nili Gilbert, and I am co-founder and portfolio manager of Matarin Capital, which is an institutional asset management firm based in New York City. I also speak with you today as the chairwoman of the investment committees of both the David Rockefeller Fund and the Synergos Institute, and as a Young Global Leader of the World Economic Forum.

I am testifying today not for Matarin Capital, but only for myself, and my remarks constitute neither recommendations nor solicitation for any investment.

I am testifying in support of the bill to amend the Securities Exchange Act of 1934 to require issuers to disclose information about human capital management in annual reports.

Asset owners from Wall Street to Main Street and many asset managers like me are increasingly seeking better understanding of

certain material nonfinancial information about the companies of which we, as shareholders, are owners.

This call would require issuers to disclose data about human capital and is rising because better insight into this field would help us to better understand the broad macroeconomic environment in which we are all operating, and also because we know that better data about individual companies can help us to generate better investment results.

This data that has been requested in this bill has been culled from the Embankment Project for Inclusive Capitalism, a multistakeholder initiative in which 32 companies representing $30 trillion in assets came together to identify human capital management practices that were found to be value-creating.

The specific items put forward in this bill should not be too onerous for companies to collect and will be broadly relevant across a wide group of companies and are supported by studies which have shown this data to be material.

As a traditional quantitatively driven investor, I can give you a sense of how lack of data availability is playing out on the ground. Our clients are increasingly interested in identifying nonfinancial risks and opportunities in their portfolios. And although we are actively seeking ways to respond to their requests, we are often running into limitations when it comes to finding the data that we need.

Since companies are not making standardized disclosures on human capital, many investors are forced to use data prepared by third-party vendors, which is subjective, less standardized, and may even contain errors. Third-party data is also very expensive, which means that the average individual investors may be at a disadvantage when it comes to their own investments.

Regulatory standards have proven effective in the past in offering frameworks that investors can rely on for receiving sound financial data that we can trust, and the same could be true in this case.

Standardizing disclosures could also help American companies by lowering their reporting burden over time. Currently, there are over 150 different rating systems of nonfinancial data which are trying to fill in the gap that has been left by a generally accepted standard. Corporate leaders have begun expressing fatigue from having to complete so many reports that are all requesting disparate kinds of data. Standardization in the future could help to mitigate this.

Additionally, intangible value is becoming an ever more important part of our economy. Traditional financial data helps us to be informed about companies' physical, tangible assets. But over the course of the past several decades, a significant portion of American companies' assets have become intangible, for example, talent and the patents that it generates.

With that being said, we are also living in a moment in history in which the role of labor in the production process is in flux. With the rise of robotics and artificial intelligence, there is an open question about how and to what extent companies will use human workers going forward.

By gathering clearer data today about issues such as worker skill gaps and training, workforce stability and turnover, and workforce productivity trends, we would have the information required to prepare for those changes of tomorrow.

I know that within these walls there have been many debates about how American institutions should behave, but I and other market participants like me are seeking information when it comes to disclosure. I believe that the markets have the potential to reflect the emerging realities of the present and the future, but as the old adage goes, we manage what we measure.

Please give us the tools that will be required to measure even more of what matters for generating successful investment returns and creating an economy that will support a bright future for the American people.

Thank you.

[The prepared statement of Ms. Gilbert can be found on page 99 of the appendix.]

Chairwoman MALONEY. And Mr. Copland, you are now recognized for 5 minutes for your testimony.

STATEMENT OF JAMES R. COPLAND, SENIOR FELLOW, AND DIRECTOR, LEGAL POLICY, MANHATTAN INSTITUTE FOR POLICY RESEARCH

Mr. COPLAND. Thank you, Subcommittee Chairwoman Maloney, Chairwoman Waters, Representative Hollingsworth, and members of the subcommittee. I appreciate the opportunity to testify.

My name is James R. Copland. I am a senior fellow with and director of legal policy for the Manhattan Institute for Policy Research, and the proposed legislation under consideration by the subcommittee today significantly intersects with my areas of research.

I believe that each of the draft bills is seriously misguided. Each is likely to retard, not promote, economic growth, and I strongly urge the committee not to take up these ill-considered pieces of legislation.

Let's turn first to the three disclosure bills. The statutory text of the Federal securities laws expressly calls on the SEC to look at material facts to be disclosed to investors, as Ms. Gilbert was suggesting.

In his opinion for the Supreme Court decision in 1976, *TSC Industries* v. *Northway,* Justice Thurgood Marshall explained that some information is of such dubious significance that insistence on its closure may accomplish more harm than good. Unfortunately, in recent years the SEC has been prodded by this body to require just the sorts of disclosures that worried Justice Marshall, as I discuss in my written testimony.

The three disclosure bills before the committee follow that trend. The pay raise bill is basically a warmed-over version of the pay ratio disclosures currently required under Dodd-Frank Section 953(b). That has been aptly characterized as a disclosure as soundbite rule, likely to prompt media stories but very unlikely to be useful to a profit-maximizing investor. There is generally little reason to expect the ratio of CEO pay and median worker pay to be constant or meaningful.

Last night the NBA held its draft lottery. Mr. Clifford is wrong. It is not the market that sets LeBron James' salary, it is the collective bargaining agreement with the NBA, and there is no reason to expect NBA salaries under the maximum contracts to have any relationship to the average wages of concession workers.

Ditto when comparing the compensation of headliner Hollywood actors and actresses against that of film crews. It is not Bob Iger, talked about by Dr. Disney, who is the highest paid employee at Disney this year. It is Robert Downey, Jr., who just got $75 million for the new "Avengers" movie.

The right comparison group for chief executives is not the median company worker, but a host of competing candidates for senior executive services, including not only other businesses, but other employers that might employ top business talent, such as private equity firms, such as investment banks, management consultancies, and, of course, entrepreneurial ventures.

The rise in executive pay over recent decades is real, but it has been driven by stock investors, chiefly institutional investors, that have sought to align managers' incentives with those of shareholders through a variety of equity compensation vehicles. The strategy has paid off. Over the last 3 decades, the broader stock market has grown tenfold.

The committee has before it two other additional disclosure bills. Each fits into that pay ratio/disclosure as sound-bite paradigm. The outsourcing bill would require companies whose stock trades on public exchanges to publish lists of workers by country, which would doubtless generate confusion. Companies using wholly-owned subsidiaries would appear to have more foreign presence than those contracting with foreign firms.

The so-called human capital management bill would require the SEC to implement a host of detailed disclosures around workforce composition and management, including diversity data and goals. But there is little reason to believe that such disclosures are material to the profit-maximizing investor in general. Indeed, over the last decade, shareholders have routinely considered and rejected shareholder proposals suggesting the publication of such data.

Let's turn to the share buyback bill. It addresses a phantom problem with a counterproductive solution. The return of capital to shareholders, more than 70 percent of which are institutional investors that reallocate capital, is the most efficient way to shift societal resources to their highest value use.

Consider that 5 of the 6 largest companies in the world today are American companies, and they simply did not exist 50 years ago. Three of them did not exist 25 years ago. Any laws or rules that would limit shareholder corporations from returning capital to investors, instead favoring retained earnings, is simply foolhardy.

Of course, companies can pay out capital through corporate dividends, but there are sound economic reasons why a company's board of directors, acting as fiduciaries, would prefer share repurchases, in many cases, to common dividends, as I outlined in my written testimony. There is simply no reason to saddle the SEC with a new study, a new rulemaking proposal, as suggested in this bill.

In conclusion, I believe that each of the draft bills is seriously misguided and likely to impede, not promote, economic growth. I encourage members of the committee to ask questions, which I will endeavor to answer to the best of my ability.

Thank you.

[The prepared statement of Mr. Copland can be found on page 65 of the appendix.]

Chairwoman MALONEY. Thank you.

I would first like to question Dr. Disney, but first comment on her very excellent article that was recently in The Washington Post on compassionate capitalism, entitled, "It's time to call out Disney—and anyone else rich off their workers' backs." I ask unanimous consent to place it in the record.

Without objection, it is so ordered.

So, Dr. Disney, you spoke really very passionately, and I would say persuasively, about the need to rein in executive compensation, and you obviously know a great deal about it and know a lot of highly paid executives.

So let me ask you a simple question. In your opinion, do most executives respond to policies that shame them for their extravagant pay packages that are just really outrageous when you see it—$79 billion versus $7.1 billion, they are paid 11 times as much in tax cuts as they are giving out to workers' bonuses and/or wage hikes—or are most of these executives absolutely immune to public shaming over their compensation packages?

Ms. DISNEY. I think that shame is probably not going to work very well unless the shame comes from inside. And that is why I think that much of the change has to be an ethos shift, a culture shift. Because pundits, commentators, people who write in newspapers about business, have all consumed and swallowed whole this idea that a company exists solely for its shareholders and solely to maximize profits, and that is simply not true. Companies have always had other stakeholders and certainly companies have moral obligations to their employees.

So that is why I argue that the median worker ratio is, in fact, not a helpful ratio, because it treats the lowest paid worker as though they are invisible or not even really employed at the same company that they are laboring at every day to promote the wellbeing of.

So I think that what needs to happen is, first of all, a shift in consciousness about what we are doing when we start a business. There are certain things that just aren't optional. If you can't afford to pay your workers a living wage, then really you can't afford to hire your workers.

And we need to stop and remember that certain things should be thought through at the beginning, at the top of the waterfall, when your revenues come in, and not at the bottom, once everybody has taken their share, so that you can give the leftovers to your employees or whomever else is being treated poorly.

As long as you have employees working full-time at your company who are sleeping in their cars, who are rationing their insulin, who are driving 3 hours each way to get to work, who are having their hours changed in a whimsical way that prevents them from being able to supplement their income with second and third

jobs, as long as any of that is happening, and your CEO is walking away with $65 million or maybe as much as $97 million in a year, this is just simply on its face morally wrong.

Chairwoman MALONEY. Thank you.

Ms. Corzo, I want to ask you about the company's human capital disclosure.

Why are the current disclosures that companies make about their workforces inadequate and what kind of disclosures do companies typically make?

Ms. CORZO. Thank you.

Right now, the basic information that investors get from companies is the number of people employed globally. It used to be that companies voluntarily would disclose the numbers in various jurisdictions, but that practice has declined in recent years.

I think that it is probably due to the fact that, first, it is not mandatory to disclose where the workers are; and second, that international firms have outsourced jobs, they recognize that that is a reputational risk, and that it is something that they probably don't want to make public if they are going to have to answer for it.

So right now there is really minimal human capital disclosure that is made available to investors. It makes it really difficult for investors to analyze effectively how companies are managing what they say themselves is their most valuable asset.

There is a lot of additional information that would be extremely useful. There is a bill today that is about offshoring. That is clearly something that is very important for investors. Investments that are made in workforce development and education, money spent on wages and benefits, gender equality issues—there are a whole list of issues that would be really valuable for investors. There is really no single factor that can tell the whole picture. But as a whole, we know that investors are extremely interested in this.

Chairwoman MALONEY. Thank you.

Ms. Gilbert, would you like to comment on that? And as an investor, what kind of human capital disclosures do you think or do you find are most important?

Ms. GILBERT. As an investor, when I think about human capital data, using the information often to try to forecast a company's business or its stock price. And so sometimes when you learn about a company's business strategy, then you look at the numbers, you may find differences.

And so we value having data as basic information to be able to evaluate whether what we hear about a company's strategy is really true.

Currently, as Ms. Corzo says, we are using information about the number of employees, but we don't have good, clean information about how those employees are being compensated, treated, their benefits, and the other issues that Ms. Corzo described.

Chairwoman MALONEY. My time has expired.

The gentlewoman from Missouri, Mrs. Wagner, is recognized for 5 minutes.

Mrs. WAGNER. Thank you, Madam Chairwoman.

And I thank Congressman Hollingsworth for yielding.

Mr. Copland, I appreciate your testimony and being so specific on the ill-guided pieces of legislation that have been brought forward today.

There has been a decline in American IPOs over the last few decades and a growing trend of American companies opting for private capital as opposed to public markets. Should we find these trends concerning? And why?

Mr. COPLAND. I think we should. I actually testified here 13 years ago on this. The IPO thing is nothing new. It is a decades-long trend at this point. We actually probably are going to have, by dollar value, a good IPO year this year. But the number of publicly traded companies has fallen.

Now, of course, the market capitalization has gone up. And so what does that tell us? It tells us that below a certain threshold, smaller companies are finding it disadvantageous to be a publicly traded company. And that is due to a host of regulations and other issues, some of which I point out in my written—

Mrs. WAGNER. I agree. And what impact do IPOs have on employment and job growth? And what does an uptick in U.S. IPOs mean for Main Street investors?

Mr. COPLAND. Well, there are two factors here, right? So one is IPOs give you a very liquid supply of capital. And it just doesn't make sense to starve new businesses of capital. That is what is going to generate jobs.

But the second fact is, the Main Street investor point is a very, very important one, because Main Street investors can invest in publicly traded stocks. They are going to have a harder time investing in private companies.

And to the extent that our capital shifts more and more into private companies, we are going to look more like Italy, where you have rich families controlling businesses, and the average worker and the average worker's pension plan is going to be less invested in that.

Now, some of this we work around, because pension plans do invest in private equity funds and what have you. But really you are going to have a disconnect and a two-tiered capital structure, which I think is unhealthy for our democracy.

Mrs. WAGNER. You have already discussed how today's hearing and the bills put forward create additional requirements on American public companies, greatly adding to their regulatory compliance costs.

None of the proposals discussed today would apply to private companies. So would these increased compliance costs for public companies deter private companies from going public?

Mr. COPLAND. Of course, they would. And they already are. That is the point. We have just seen—until maybe this year, we have seen a real retreat in IPOs. We have seen consolidation. We have seen fewer publicly traded companies.

And as someone who has invested in startup businesses, they don't want to go public. The last thing they want to do is go public because of all of these requirements.

Now, clearly, as Representative Sherman suggested, this body, Congress, has the constitutional power under current Supreme

Court doctrine to start expanding its role into private businesses, but I think that would be really misguided.

Mrs. WAGNER. Mr. Copland, in your testimony you described stock buybacks as "good for investors," and that they "help to protect investors' interests, promote efficient capital markets, and facilitate capital formation."

Can you explain why one-size-fits-all limitations on a company's ability to repurchase its stock or a complete ban on buybacks could result in the inefficient allocation of capital for a company and hurt the economy and wage growth in the long run?

Mr. COPLAND. As I suggested in my oral testimony, we have a dramatic reshifting all the time of money from one value to another, and that is driven by these capital markets. So it shouldn't be surprising that there is a large number of share buybacks when there are tax law changes. In fact, the tax law changes would prompt investors to want to reallocate capital based on that shift.

And that is why we have a market now that has companies like Facebook and Amazon and Google, which just didn't exist 25 years ago at all, valued so highly, because we have these liquid markets.

Now, if you just constrain it to corporate dividends, then you are constraining boards' ability to take advantage of their information, if they think the stock is mispriced, but you are also creating necessary capital events if you actually pay out your earnings to shareholders, which means that an investment firm like Ms. Gilbert's buying and selling securities is going to be getting more taxable events.

So you are not helping your investors out. You may be generating a little tax revenue, but you are not helping investors out by—

Mrs. WAGNER. And quickly, I may not have enough time, but how would executive pay ratio disclosure, as proposed, further solidify proxy advisory firms' influence over corporate governance matters for U.S. public companies? And what are the consequences of increased proxy advisory firm influence for public companies and their shareholders?

Mr. COPLAND. Proxy advisory firms are a big topic. I have written a lot about it. I have some in my written testimony.

I don't think the pay ratio is going to affect how they behave, because I don't think it is material. I don't think they are going to pay a lick of attention to it.

Mrs. WAGNER. I yield back. Thank you.

Chairwoman MALONEY. The gentlewoman's time has expired.

The Chair of the Full Financial Services Committee, Chairwoman Waters, is now recognized for 5 minutes.

Chairwoman WATERS. Thank you very much. And, Mrs. Maloney, this is a most important hearing.

As I came into this room, I heard some of the testimony. And I want to make a few comments before asking a question or two, and say to Dr. Disney, I am so proud of you and your courage. I am so proud that a woman who could enjoy all of the privilege that she would want to enjoy would have the compassion and the commitment to go public and to come before this committee and tell the truth about what is happening at the family business.

We don't have many people like that here in Washington, D.C. You are a prime example of what a real American citizen is. Thank you so very much for your courage.

[applause]

Chairwoman MALONEY. The committee will come to order. And please respect the orders of the committee, which is no clapping, just focusing on the importance of the issues we are talking about.

Thank you so much.

Chairwoman WATERS. Thank you for reminding us, Mrs. Maloney, but I loved that clapping.

Chairwoman MALONEY. I did, too.

Chairwoman WATERS. Thank you.

Just a couple of questions.

Ms. Gilbert, I heard you when I first came in, and I was pleased to learn that you are a co-founder of your firm and that you are working with CalPERS and maybe even CalSTRS. I was an assemblywoman at one time in the State of California and created the emerging fund for asset managers to break into the possibility of managing these firms in the State of California.

Can you tell me, when you talk about this information that is so important to making good investment decisions, specifically what are you talking about? Are you talking about knowing as much as you can possibly know about all of the employees? What kind of information? How does that really help you?

Ms. GILBERT. Thank you, Madam Chairwoman. I am familiar with the work that you did in the State of California. Without that work, Matarin wouldn't exist today, so I'm very grateful.

There is something in investments called the fundamental law of active management, which says that the returns that you can generate in a portfolio are proportionate with the amount of information that you have about the securities that you may be potentially investing in. Of course, it is important that it be relevant, material information.

We have seen, and you will note in the written testimonies, many academic studies that show that the data that has been requested in the bill on human capital management has been proven in academia to be material, but as investors it is very important for us to take in clean data and evaluate it ourselves as we would apply it in the markets.

I also would note that when we think about issues of human capital management today, that this has become a hugely important part of the American economy. When you look at our largest four sectors, it is technology, healthcare, financial services, and communications, all of which rely very heavily on talent and people to yield their success.

Without having good clean information about how that talent is being managed, we are simply not able to get a clear picture of what these key companies in our economy are truly doing.

Chairwoman WATERS. Thank you very much. I appreciate that information.

I think it was Ms. Corzo who talked about buybacks. And, we have gone through the President of the United States having initiated a tax reform bill—so-called reform—where these companies told us and told the world that they were going to invest in their

employees, that they were going to expand the inventory, on and on and on, and they were going to increase pay and bonuses, but they did not.

Would you recommend that we go on record in terms of buybacks and that we use the power of this Congress to eliminate the ability to use funds that have been generated by tax reform from being used for buybacks?

Ms. CORZO. Thank you.

Yes, I think it is critically important that Congress take affirmative action to address the problem of abusive stock buybacks. As you mentioned, the Trump tax bill triggered $1 trillion in stock buybacks last year. That is a trillion dollars that could have been invested in raising workers' wages, in developing research and new products, and in corporate growth that would drive our economy into the next several decades.

So absolutely, I think this is a problem. I think that business today is eating the seed corn of the future. And we really need affirmative policies to stop the financial engineering and focus on what really matters in our economy.

Chairwoman WATERS. Thank you so very much.

And I yield back the balance of my time.

Chairwoman MALONEY. Thank you very much, Chairwoman Waters.

The gentleman from Indiana, Mr. Hollingsworth, is recognized for 5 minutes.

Mr. HOLLINGSWORTH. Dr. Disney, I appreciate you being here. And like Chairwoman Waters said, I appreciate the verve and passion that you have for this issue.

I heard you several times say that the CEO of Disney makes too much money. I wondered if you might tell me how much money he should make?

Ms. DISNEY. Thank you for that question.

Mr. HOLLINGSWORTH. Great.

Ms. DISNEY. I wouldn't begin to tell you what the number is that he should make.

Mr. HOLLINGSWORTH. Okay, great. Tell me, what should—

Ms. DISNEY. But let me—

Mr. HOLLINGSWORTH. Reclaiming my time, you don't know what the number is?

What should the pay ratio be between the median wage of Disney employees and the CEO of Disney?

Ms. DISNEY. First of all, I believe that the ratio should be measured to the bottom worker.

Mr. HOLLINGSWORTH. I know. That is what you said. I will ask you that question next.

Ms. DISNEY. If you take his salary and assume he works a 60-hour week and never takes a vacation, he is being paid $21,000 an hour.

Mr. HOLLINGSWORTH. Got it.

Ms. DISNEY. So I would argue that that is on its face too much money for anyone.

Mr. HOLLINGSWORTH. What is the right number then?

Ms. DISNEY. It would be closer to $10,000 an hour and maybe lower than that.

Mr. HOLLINGSWORTH. Is $10,000 the right number for every CEO of a public company or just Disney?

Ms. DISNEY. Of course not. And as I said in my remarks, there is nothing inherently wrong with a $65 million payday, as long as his employees are not going home and rationing insulin.

Mr. HOLLINGSWORTH. Yes. You also mentioned that you believe every employee should be paid a living wage. Will you tell me what that living wage is in San Francisco?

Ms. DISNEY. I would tell you that there are economists who could tell you what the living wage is—

Mr. HOLLINGSWORTH. What is the—

Ms. DISNEY. —in different cities depending on the cost structures in those cities.

Mr. HOLLINGSWORTH. Reclaiming my time, what is the living wage in Salem, Indiana? What is the living wage in Salem?

Ms. DISNEY. I don't know. But I do know in Anaheim, it is $24.

Mr. HOLLINGSWORTH. The point I am trying to make is we are throwing around numbers here on appropriate CEO pay, what CEO pay should be, what the living wage should be in X city. But there aren't any specifics on how we will do that, right?

And what I continue to hear from you and others is, oh, we will just defer to a group of scientists who will endeavor to figure out what the appropriate CEO salary is, what the appropriate median wage is, what the appropriate living wage is, in every single location for every single job, up and down the spectrum, sea to shining sea. We have a definition of that. That is socialism. We know what that is.

Ms. DISNEY. Okay. So—

Mr. HOLLINGSWORTH. So, with respect, reclaiming my time, Mr. Copland, I want to talk about the outsourcing bill that has been presented. One of the challenges associated with this particular bill is that it merely outlines the number of employees located in the U.S. versus another country.

So if I purchase a fully constructed product that was manufactured in China, and I have a single employee in the United States who just distributes that out, I have 100 percent of my workforce in the United States. But if I purchase—50 percent of that product's value-add, manufactured in China, 50 percent of the value-add is here in the United States, I have 10,000 employees in both, only 50 percent of my workforce is in the United States. So it looks like I am outsourcing jobs when, in fact, I am creating more value for that product in the United States in the second example compared to the first.

I wondered if you might elucidate what some of the challenges are around this simple ratio in trying to glean real and meaningful information, which Ms. Gilbert rightfully talks about, from such a simple metric.

Mr. COPLAND. I don't think you can have meaningful information. I think you have elucidated it exactly right. There is just no way to take an aggregate number.

And you are not going to be able to force a Chinese manufacturer to disclose its workforce data. So the company here that is largely an import company is going to look like it has more domestic prod-

uct than the one that is manufacturing here but has subsidiaries overseas.

Mr. HOLLINGSWORTH. Right. Exactly.

I wondered if you might also talk a little bit about some of the challenges about the pay ratio and how some of those disclosures might lead to misinformation rather than information, just in the metric by which it is calculated.

And I believe there was a recent article that even elucidated how variable this is year to year for individual companies and how it leads to really perverse outcomes.

Mr. COPLAND. It is going to vary year to year, because, driven by investors, as I said in my oral testimony, most executives are now paid with some sort of equity compensation plan. And that is to ameliorate what economists call agency costs and align them with other shareholders. So the top line is going to go up and down. The other line is going to be relatively flat.

But it is also going to create a lot of distortion, because some companies may choose to have in-house workers who are lower-value workers; others will contract out with subcontractors or foreign companies to provide goods and services. And, therefore, you are going to have a mismatch. And, again, the company that looks like its ratio is small may be small because it is outsourcing and subcontracting more.

Mr. HOLLINGSWORTH. I absolutely agree that data is really important. But having the right data and having the right metric is what we should be looking for, not just simple metrics here.

And with that, I yield back.

Chairwoman MALONEY. Thank you. Without objection, and consistent with past committee practices that have allowed filming at the request of a witness, the cameraman associated with one of the witnesses is permitted to film this hearing. And this is a unanimous committee request.

Mr. HOLLINGSWORTH. Reserving the right to object, I think it is important to go on the record that the Minority was not consulted prior to this discussion. Consistent with House rules, filming by a nonaccredited person or entity may only occur by consent of the Full Committee. I would ask that moving forward, the Majority consult with the Minority to ensure that the House rules are followed appropriately.

Mrs. WAGNER. I refer the Parliamentarian a question. Am I recognized?

Chairwoman MALONEY. The gentlewoman is recognized.

Mrs. WAGNER. Thank you. I have been on this committee now for 4 terms, 8 years. I have never been aware that a witness has brought in their own filming crew for—I don't know what it is for, documentation—documentary, political purposes. Is this being covered by C-SPAN as usual? Are we aware? This hearing?

Chairwoman MALONEY. Parliamentary query. On April 30th, the committee accommodated Daryl Carter from the Multifamily Housing Council, a witness chosen by the Republican side. I note that the cameraman is remaining stationary for the remainder of this hearing.

Mrs. WAGNER. I think that was litigated unilaterally by the Majority. The Minority was not aware. I am just wondering what the filming crew is—

Chairwoman MALONEY. There is no parliamentary inquiry.

Okay, the gentleman from Georgia, Mr. Scott, is recognized for 5 minutes.

Mr. SCOTT. Thank you very much, Madam Chairwoman. Mr. Copland, let me start with you. I listened intently to your remarks. You said this: You said that it is assumed, meaning diversity, the data, the composition, that this whole issue is assumed to be of little interest to "profit-maximizing investors." I want you to explain that. But then you go so far as to describe this issue of diversity as fitting within "a disclosure as a sound bite."

Now, Mr. Copland, let me give you the latest data, because I think that you have generalized here. And with all due respect, of course, everybody has their opinion, but let me share with you the latest information on this, and then you tell me if what we are discussing needs to be just a sound bite. African Americans and women and other minorities are drastically underrepresented in the top tiers of our companies and our corporate leadership.

For example, here are the latest facts: Women represented just 5 percent of Fortune 500 CEOs in 2018. If that is not bad enough, even this number in 2018 has declined from what it was in 2017. The number of African-American CEOs running Fortune 500 companies last year; it was just three people. And even that number has also declined in previous years.

So the carelessness with which your testimony has pierced this committee, when it comes to the inclusion, the participation, and your denial and diminishing the significance of the problem, certainly raises a great deal of eye-opening realization as to why we are having this hearing, and why I hope that my information that I have relayed to you during this committee hearing, will broaden your perspective and enlighten you to some facts that you are obviously dimly aware of.

Mr. COPLAND. Am I supposed to be able to respond to that?

Mr. SCOTT. Please do, sir.

Mr. COPLAND. Yes, what I was saying was not at all that there is equal, or even yet representation in terms of CEOs, based on different racial minority groups or women or anything like that. And I am not saying that is not a matter of concern. It is also not very related to this bill, right? It is very easy to get data on whether the CEO is a woman, or is a racial minority or what have you. So, investors are able to trade on that. What you are talking about here is a panoply of other disclosures. And when I am talking about what profit-maximizing shareholders think, I mean, I run a website—proxymonitor.org. I track shareholder proposals at these big companies. These sorts of disclosure rules have been introduced in shareholder proposals time and again. A majority of shareholders, time and again, have voted against them.

Now, that doesn't mean that a quantitative fund manager like Ms. Gilbert may not be able to get certain data that could be valuable to her as an investor, but I want to caution the committee that the actual investment response there may not be what you think.

Mr. SCOTT. I only have 5 seconds. I want to give Ms. Gilbert and Ms. Disney time to give their viewpoint on this, because this is important. This is the heart of what we are talking about here. Do you all see what I am saying here?

Chairwoman MALONEY. Mr. Scott, your time has expired, and maybe the next questioner on our side can follow up on your question. But right now, the gentleman from Arkansas, Mr. Hill, is recognized for 5 minutes.

Mr. HILL. Thank you, Madam Chairwoman. Thanks for convening this hearing on these bills. It is good to have this very knowledgeable panel before us. I want to start with a quote from Warren Buffett, the chief executive at Berkshire Hathaway, who is clearly a recognized writer and thinker, as well as practitioner in that area, and Mr. Buffett says stock buybacks are sensible for a company when its shares sell at a meaningful discount to conservatively calculated intrinsic value. Indeed, disciplined repurchases are the surest way—surest way—to use funds intelligently. It is hard to go wrong when you are buying dollar bills for 80 cents or less.

Mr. Buffett goes on to remind managers, however, to never forget that in repurchase decisions, price is all-important. Value is destroyed when purchases are made above intrinsic value.

So this discussion today about buybacks, I want to start out following up on Mr. Buffett with some facts. First of all, no company wants to either buy stock back or pay too much in dividends, because that would mean their stock will be out of place in the competitive capital market. But if you look since 1880, companies have a process of returning about 73 percent of earnings since that time, 140 years. And they do that through both dividends, and now, in the last 40 years or so, through net share buybacks. 2018 was about 88 percent percentile, versus that median since 1880, of 76 percent, so it is up higher.

But if you look in 2018, why is it up higher? Why is it spiked up in 2018? It is partially due to companies returning capital to the United States, capital that was trapped outside the United States, and freed up from the tax reform which, for 40 years, was a bipartisan objective to reduce the double taxation on international American profits, not so bipartisan recently.

And if you look at the numbers in 2018, just 20 stocks out of the S&P 500 accounted for 70 percent of the buybacks, Madam Chairwoman. And those were what, the companies that had the most money trapped overseas. So as Mr. Buffett notes, there are benefits in our economy to bringing those dollars home to the United States, benefiting shareholders. Who are the biggest beneficiaries? Shareholders. The money doesn't disappear; it goes to the AFL-CIO pension fund.

They have an S&P 500 index fund that they operate. It is benefited. CalPERS, mentioned by our Full Committee Chair, has 50 percent of its exposure to global equity. They benefit. Those pensioners benefit. It allows them to use that money for the highest and best use.

And, finally, I am hearing consistently today and previously on both sides of the aisle, complaining that if one is doing a buyback, that one is not investing in research and development, not devel-

oping HR, human resources issues, not involving capital expenditures to increase growth and jobs and productivity in the United States. 2018's numbers. 2018's numbers, 14 percent in the S&P 500 increases in capital expenditures, a high since 2011. And in R&D spending, 11 percent, a high since 2006. And Edal, at 11 percent, that is the median over the entire history that I could find on R&D spending as a percentage of revenue in the S&P 500.

So, Mr. Copland, given that, and given your work on this topic, do you agree that a buyback is a part of capital allocation that should be under the market pressures of people like Ms. Gilbert, and important institutional investors, or the AFL pension fund, for scrutiny, but that it is a way to let capital recirculate in our economy? Do you agree with that?

Mr. COPLAND. It is a vital way, and it is just unambiguous. To suggest that the companies ought to retain all their earnings is effectively saying, we want our economy organized around U.S. Steel and International Paper, not Google and Facebook. That is just crazy.

Mr. HILL. And, Mr. Copland, also, on the pay ratio, what is a better way to define it? I hear so many complain that they don't like the median income test, and others don't like the complexity of it. Could you submit in writing for the record—and also, Dr. Disney, if you would as well—submit for the record, how does that ratio, if it is so important to so many stakeholders, how should it be redefined, because I think most people are very frustrated by it, maybe on both sides of the argument.

Thank you, Madam Chairwoman. I yield back.

Chairwoman MALONEY. Thank you. The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. The gentleman who just spoke talked about the importance of R&D spending, I think it is critical for our economy. I would point out that the Ways and Means Committee has put into our tax law, at substantial cost to American taxpayers, incentives to encourage R&D, but this committee has, without paying any attention to it, allowed the SEC to allow the FASB to put in dramatically illogical accounting theory-wrong, accounting standards that discourage expenditures on R&D. And if we care about R&D, and we care about the responsibilities of this committee, we ought to be taking—we ought to be acting to repeal FASB pronouncement number 2, which discourages R&D, and at a time when Congress has decided it is worth taking money away from people and from important programs and to—only to encourage it.

We are talking here about CEO pay. And when we talk about CEO pay and we use that to drive up wages a bit, that is a good thing. But we need an economic policy that creates a labor shortage so that we will see real wage increases that we need, and we need to educate and provide apprenticeship programs for our workers so that they are more valuable and are paid more.

But when we talk about CEO pay in the context of a fair society, let us remember that the heirs and the entrepreneurs have far more money than the CEOs and that if we want to deal with fairness, it is not a matter of just taking some big-name CEO and having them paid less. We need a much more progressive income tax. We need an estate tax that matters, the way we did under Ronald

Reagan. We need, perhaps, a wealth tax as proposed by at least some Senators, and we may consider taxes on unrealized capital gain. But for us to say that all of the problems with wealth distribution are because of 5 or 10 CEOs, or 20 or 30 CEOs, is absurd.

I will point out that Jeff Bezos probably makes more money than Bob Iger by a long shot, but he has no salary at all. He pays himself nothing. It is all in unrealized appreciation, minus divorce expenses.

Mr. Clifford, when a corporation has more—makes money, it can either invest it, if it has good places to invest it, it can use it as reserves, or it can distribute it. So we are going to see some corporate distributions. In fact, if there were no corporate distributions, nobody would own stock, and every share would be worthless. So the issue is, share buybacks versus dividends. Back in the old days, companies paid dividends. Most CEOs have stock options. Does a CEO benefit more if the money is paid out as a stock buyback, which raises the value of the remaining shares, as opposed to a dividend?

Mr. CLIFFORD. The CEO, assuming he is going—assuming they make that calculation, they will calculate what will maximize stock price.

Mr. SHERMAN. And do most stock options have an adjustment for dividends paid while the option is outstanding?

Mr. CLIFFORD. Most do.

Mr. SHERMAN. Most do. So that the CEO might—would benefit; if you retain the money, the stock is worth more?

Mr. CLIFFORD. He might.

Mr. SHERMAN. He might?

Mr. CLIFFORD. He is certain to benefit when—

Mr. SHERMAN. And I will point out on diversity, I just slipped into referring to the CEO as a "he," and maybe I have spent—

Mr. CLIFFORD. Ninety-five percent.

Mr. SHERMAN. I know, that is 95 percent true. It certainly shouldn't be. Go ahead?

Mr. CLIFFORD. The CEO has a compelling quick way to cash out when he has a buyback. An increase in the dividend provides—and I will use the male pronoun now—provides him a small amount of money. So those things are not the same as far as somebody who is planning to cash out soon—

Mr. SHERMAN. Is there another reason corporations have preferred the buyback, rather than the dividends of old? Is there a tax advantage still? There used to be a tax advantage.

Mr. CLIFFORD. No, I think it is—I think what happened—there are two drivers. One is that it benefits the executives who are cashing out. It also keeps the activist shareholders off their backs. So those are two great incentives to have a buyback rather than a dividend and a reinvestment.

Mr. SHERMAN. Well, let's hear it for—

Chairwoman MALONEY. The gentleman's time has expired.

Mr. SHERMAN. —activist shareholders, and I yield back.

Mrs. WAGNER. Madam Chairwoman, I believe I have a parliamentarian inquiry at the table here. I don't believe the UC has been properly propounded, so I have a couple of questions. I see that Dr. Disney—

Chairwoman MALONEY. Well, first of all, I would like to ask, does the gentleman withdraw his reservation?

Mr. HOLLINGSWORTH. I do. Our concerns have been noted on the record.

Chairwoman MALONEY. Okay.

Mrs. WAGNER. I reserve the right to object.

Chairwoman MALONEY. You object that he is withdrawing his reservation?

Mrs. WAGNER. I am reserving the right to object. And I have a couple of questions.

Chairwoman MALONEY. I don't believe you can reserve at this point.

Mrs. WAGNER. He withdrew his, so I—

Chairwoman MALONEY. Our understanding is that the filming is for a personal biography for Dr. Disney.

Mrs. WAGNER. And that is my question—

Chairwoman MALONEY. I now recognize the gentleman from Ohio—

Mrs. WAGNER. Madam Chairwoman, a parliamentary inquiry. I would like to know the purpose of the filming. It is highly unusual that Dr. Disney, or that any witness would not use the C-SPAN coverage and would bring in their own professional film crew. I am wondering if this is going to be shown to the public. I am also wondering, Madam Chairwoman, if this is for profit or a not-for-profit entity, and I would just like those questions answered if possible, please, by my friend, the Chair?

Mr. SHERMAN. If the gentlelady will yield—

Chairwoman MALONEY. I would like to clarify, the hearing is not being filmed by C-SPAN. Subcommittee hearings frequently are, but this one is not being filmed by C-SPAN.

Mrs. WAGNER. And what is the purpose of Dr. Disney's professional film crew being here? Is this being personally used? Is this being shown to the public? Is it a for-profit or a not-for-profit entity?

Ms. DISNEY. Should I answer?

Chairwoman MALONEY. It is for a personal biography, is my understanding.

Correct me if I'm wrong, Dr. Disney, personal?

Ms. DISNEY. I am happy to answer. I am hoping, perhaps, to make a film about the issue of income inequality. And this might figure into it in some way, so we brought a—

Mrs. WAGNER. So this is a documentary film—

Ms. DISNEY. Yes.

Mrs. WAGNER. —that will be shown to the public?

Ms. DISNEY. Yes.

Mrs. WAGNER. Is this a for-profit or not-for-profit entity?

Ms. DISNEY. It might be a for-profit entity, but I have certainly never seen a profit on any of it. But it is likely maybe to be seen at film festivals, or we may never use any of the footage we are shooting here.

Mr. SHERMAN. Will the gentlelady yield?

Mrs. WAGNER. Yes.

Mr. SHERMAN. I have seen news cameras in hearings for the last 22 years. I am told that Fox News is a profit-making entity, so—

Mrs. WAGNER. Reclaiming my time. I don't believe this is a—I don't believe that this—

Chairwoman MALONEY. This is not a proper parliamentary inquiry at this point.

The gentleman from Ohio, Mr. Davidson—

Mrs. WAGNER. I object—I object to the UC.

Chairwoman MALONEY. —is recognized for 5 minutes.

Mrs. WAGNER. I object to the UC and I have a parliamentarian inquiry at the table, and I would like to—I do not believe that a film crew is an accredited news organization. This is not the press. And you are telling me that this may be used for you as a for-profit entity, and shown to the public?

Ms. DISNEY. Perhaps, and believe me, it will be part of a larger not-for-profit—

Mrs. WAGNER. Again, going back, and I will yield back my time, but as the ranking member, currently, Congressman Hollingsworth has said, it would certainly be appropriate in the future if the Full Committee has—is aware of this, these goings on, and can certainly—

Chairwoman MALONEY. Your objections have been noted, and in the interest of time, I think we should move forward.

The gentleman from Ohio, Mr. Davidson, is recognized for 5 minutes.

Mrs. WAGNER. Do you see this?

Mr. DAVIDSON. Thank you, Madam Chairwoman. I thank our witnesses. And as a point of clarification, am I to understand, Madam Chairwoman, that the only public record of this isn't really public; it is privately owned by Ms. Disney or whomever she has contracted? There is no record provided by C-SPAN on this?

Chairwoman MALONEY. That is my understanding, that this hearing is not being filmed by C-SPAN for some reason.

Mr. DAVIDSON. Move to adjourn.

Mr. SHERMAN. The committee has a—

Chairwoman MALONEY. Okay. Move to table.

Mr. SHERMAN. Move to table.

Chairwoman MALONEY. Okay. All those in favor of tabling, say aye. Aye. All those opposed, say no. No.

VOICE. Parliamentary inquiry.

Chairwoman MALONEY. In the opinion—

VOICE. —adjournment. That is not proper.

Chairwoman MALONEY. The ayes have it—in the opinion of the Chair, the ayes have it.

Mr. STIVERS. You cannot table an adjournment, Madam Chairwoman. You have to vote on it.

Chairwoman MALONEY. Well, let's—all those in favor of the move to adjourn, say aye. Aye. All those opposed, say nay. Nay. In the opinion of the Chair, the nays have it.

Would you—Mr. Davidson is now recognized.

Mr. DAVIDSON. Thank you, Madam Chairwoman. As a further point of clarification, is there a record that can be made public that is provided by the committee and not C-SPAN?

Chairwoman MALONEY. It is online.

Mr. DAVIDSON. Thank you, Madam Chairwoman.

Chairwoman MALONEY. All right. Mr. Davidson, are you going to continue with your questioning?

Mr. DAVIDSON. Yes. So as my time rapidly burns away for non-productive activities, we would like to talk a little bit about productive activities, which is how do we make America continue to be the world's land of opportunity? We see that every day, because people from around the world want to come to the United States. Personally come. They want to move their companies here. They want to move their capital here. They want to put their intellectual property here. What is increasingly true, is, they do not want to go public here, particularly small companies don't want to go public here, and while I can't endorse all of the recommendations of this paper, I believe the research on the topic is important, and I would ask unanimous consent that this paper for the Harvard Kennedy School by Marshall Lux and Jack Pead be submitted into the record.

Chairwoman MALONEY. Without objection, it is so ordered.

Mr. DAVIDSON. I think the debate here is really, in some way, about who owns the capital. So if someone owns the capital of a company, they are a single shareholder and they decide, let's go public and share in this upside of the company, we will get the capital to scale it. That has historically been the reason that they go public. But as we have the debate here, as my colleague, Mr. Hollingsworth, pointed out, we are looking at socializing that. And not even socializing it for the people who actually own the shares or own the capital, but because we vote here in Congress that somehow you don't actually own the capital, that you don't actually have the discretion of what to do with your company, that the board couldn't possibly be trusted to set the compensation package for the officers and directors of the corporation. And you couldn't possibly trust the officers and directors of the corporation to compensate their employees. That you couldn't possibly trust private owners of capital with the decision of whether or not to buy shares and at what price to buy them.

So as my colleague pointed out, if you don't want to call this socialism, I suppose you can call it something else, central planning, Marxism, neo-Marxism, something that takes away the private ownership of capital. So I look forward to the words that define it, but it certainly isn't the path that made our country the world's land of opportunity.

Our country has outperformed the world in every rational metric with respect to capital formation. We have the best markets for goods, services, capital, intellectual property, and historically, for people. But I was intrigued as my colleague, Mr. Sherman, talked about labor and the labor market. We need to create labor shortages. We have the lowest unemployment on record for every demographic that we track it for, and we increasingly track it by an amazing number of parsed definitions of identity. And it is the lowest on record for everything that we can track. And at the same time that is true, these socialist ideas for forming, and gaining traction with a certain segment of our society, including people who are benefiting greatly.

And so, Ms. Corzo, you touched for a little bit in your testimony regarding private equity, and since you have raised the topic, I

heard recently that there is a private equity-funded project at the JFK Airport that is putting 4,000 union members to work and will create 8,000 permanent union jobs upon completion. Can you tell us how many AFL-CIO workers are currently employed by private equity-backed funds?

Ms. CORZO. When we talk about private equity, the reason that we are concerned is because of the impact on the economy—on workers, on pension plans, and on the excessive risks that we are seeing in the corporate debt markets as a result.

So, while it is true that there are some union members who are employed by private equity-owned companies, the reality is that the strategy we see, time and again, when private equity firms—

Mr. DAVIDSON. So, reclaiming my time. Is the purpose here to grill America's economy or to grill the union workforce? And the reality is not just union workforces, the entire American workforce is benefiting from this era of prosperity. My time has expired.

Chairwoman MALONEY. The gentleman's time has expired.

Without objection, and consistent with past committee practices that have allowed filming at the request of a witness, the cameraman associated with one of the witnesses is permitted to film this hearing.

The gentleman from Illinois, Mr. Foster, is recognized for 5 minutes.

Mr. FOSTER. Thank you, Madam Chairwoman, and thank you to our witnesses.

Ms. Disney, the paths of your family's company and mine crossed about 40 years ago when, I guess, I was about 25 years old. I designed and programmed the control system for the Disneyland Main Street Electrical Parade. And that was one of the first big contracts for our company, which is something that my brother and I started in our basement with $500 from my parents. And our company is big and successful. It employs over 1,000 people today and manufactures in the Midwest, which is something I am very proud of. But our companies are actually—the companies of our families have gone down different roads in recent years.

You describe a path that you are not completely happy with, that your family's company has gone down. In our case, we have chosen an employee-stock ownership plan, an ESOP, where you get an equity stake by the workers in their company. And I was wondering, you know, I see a lot of merit in this. I see it not only in sort of a social justice point of view, but also in just the enthusiasm that the employees have in the continued survival and thriving of your company.

So I was wondering if any of the witnesses, Mr. Clifford or anyone else, has a comment on the ESOP model as a way to try to better align the incentives of the corporation and the workers?

Ms. DISNEY. Disney had an employee stock ownership program which has gradually dissipated, and has ultimately disappeared, especially for workers at the lowest level. It has been pushed more generously and more uphill than it has ever been. And the important thing to note here is, we are having kind of this parallel conversation about what is good for investors, and what is good for people who work. And it is important to note that 80 percent of stocks are held by 10 percent of Americans.

So, yes, it is wonderful that capital markets move unrestrained, and no one is suggesting socialism, and no one is suggesting a one-size-fits-all—and it is an absurd suggestion to say that we are—but what we are saying is that, yes, boards cannot be trusted to compensate well and fairly for the reason that most of the people monitoring that compensation are CEOs or want to be CEOs, and they will not peel off from orthodoxy about compensation. They can't be trusted to increase diversity. There are more CEOs named John in the Fortune 500 than there are women CEOs overall. So we know that—

Mr. FOSTER. Thank you. Do any of our other witnesses have any comments on ESOPs?

Ms. CORZO. There are certainly benefits of ESOPs in terms of alignment of interests between the workers and the other share owners. There are also complications that can arise. I think from a worker perspective, when a worker is choosing how they are compensated, clearly cash is the best form of compensation.

In addition to this, there are examples that will often make workers somewhat concerned about employee stock ownership. Mrs. Axne mentioned her tenure with the Tribune company, this is an example where an ESOP was not successful and the workers felt like they ended up on the losing end of the deal. And so, there are a lot of tricky complications that can come into play, but clearly, when we have so much money that is being allocated to shareholders, giving workers a stake in that would be helpful.

Mr. CLIFFORD. When they work, they are a thing of beauty, but they are very hard to pull off, as you undoubtedly know.

Mr. FOSTER. Yes, you have to be very careful that the workers understand the risks of future performance of the company and then—

Mr. COPLAND. Yes, just to clarify, we have seen ESOPs in certain industries, particularly those with hostile union relations, there are significant risks to an ESOP in the sense that the worker is already at risk of losing his or her job, but if you wrap their pension up with the company, too, you could put their retirement security in the same place. We saw that with the collapse of Enron, where a lot of workers were invested in the company.

So there are problems with it, and just generally there is a reason why we have share ownership versus employee ownership. I would recommend to the committee Professor Henry Hansmann's book, "The Ownership of Enterprises," which goes through employee-owned and other sorts of ownership structures and explains sort of why that is. It is too complicated to get in here.

Mr. FOSTER. Ms. Gilbert, I was interested in your comments having alluded to the looming problem of robots taking everyone's jobs, basically, and so is there a concern here that by effectively making—adding expenses to human workers that someone—that a CEO faced with a choice of either making an investment in human resources, or just buying new hardware, that you will be pushing things in the direction of hardware that displaces jobs, rather than creates them?

Ms. GILBERT. Yes. Thank you for your question. This is the concern that I was hoping to raise in my testimony. Currently, we don't have the data available to be able to study this issue at the

individual company level. But as all of you know, this is really a national issue. If we think about our national economy as an aggregate of all of the individual companies in it, then if we were able to get better data about worker turnover—

Chairwoman MALONEY. The gentleman's time has expired.

Mr. FOSTER. I yield back.

Chairwoman MALONEY. The gentleman from Wisconsin, Mr. Duffy, is recognized for 5 minutes.

Mr. DUFFY. Thank you, Madam Chairwoman. Welcome, panel. There were, I think, 26 institutional investors or groups that supported one of these bills that is being advanced by the Majority on disclosure of human capital management. CalPERS, CalSTRS, UAW, I think AFL-CIO is part of that as well. Does the panel know whether CalPERS, UAW, and the AFL-CIO make the disclosures that they are requesting of private corporations?

Ms. CORZO. I can tell you, from the AFL-CIO's perspective, that we make extensive personal information about each employee and their salary available in accordance with the Department of Labor's request.

Mr. DUFFY. But you recommended a set of standards for public companies. Do you abide by the standards that you think the public companies should abide by? Do you abide by those at the AFL-CIO?

Ms. CORZO. We disclose a tremendous—

Mr. DUFFY. That is not my question.

Ms. CORZO. —amount of information.

Mr. DUFFY. Not my question.

Ms. CORZO. Also, we are not a public company.

Mr. DUFFY. I know.

Ms. CORZO. We are not asking for investors. We are not asking for capital—

Mr. DUFFY. I will take your answer as, no, you do not. You do not. UAW does not. We do not know the pay disparity. We don't know the gender breakdown. We don't know the minority breakdown. And I find it fascinating what is good for the goose is not good for the gander.

Ms. CORZO. At UAW, we actually do know the pay disparity—

Mr. DUFFY. I am going to reclaim my time. I think this is a better place in the work that, Ms. Corzo, that you are involved in, for shareholder initiatives. Let the owners of the companies decide. You can bring forward an initiative. Have a vote. But to have this dictated from Congress, I have a fundamental disagreement, and there are a lot of priorities that come before public companies. Let them have a vote. This is a democracy. But to mandate this by the Congress, I have a fundamental disagreement.

And I would just note in regard to pay—and this might be different in different parts of the country—in my community, over the last 2 years, there are so many jobs. We have more jobs available than people to fill the jobs. And so if you are a minority, if you are a woman, or if you are anybody else, and you are not being treated fairly, you are not getting compensated fairly, guess what, you pack up and go down the street, and you do get compensated fairly. Because another company will snatch you up and hire you and pay you your worth.

It is happening all over my community, to the frustration of employers that there is poaching of the workforce. One second, I am going to get to this other point. I apologize, and you can answer when I come over to you. But you all are here, most of you are here, in regard to public disclosure. We want public disclosure.

So, Mrs. Maloney, I can tell you that she makes $174,000 a year, and so does everybody else up here. It's pretty tough for any of these other people to make any more money. So to the panel—Mr. Clifford, let's start with you—how much do you make, not just on your salary, but on your investments? I can't wait to get to Ms. Disney.

Mr. CLIFFORD. I don't have a salary. I don't work. I am retired.

Mr. DUFFY. Your investments, then.

Mr. CLIFFORD. On my investments—

Mr. DUFFY. You can take out Social Security.

Mr. CLIFFORD. On my investments and my board fees, about $450,000 a year.

Mr. DUFFY. Ms. Corzo?

Ms. CORZO. I am not going to disclose my personal income.

Mr. DUFFY. You are not going to disclose? Surprising.

Ms. Disney?

Ms. DISNEY. Somewhere in the range of $5 million to $6 million, but I also give away about $7 million to $8 million a year.

Mr. DUFFY. Say that one more time?

Ms. DISNEY. Somewhere in the range of $5 million to $6 million annually. I also give away $7 million to $8 million annually.

Mr. DUFFY. Because you are worth about half a billion dollars? Is that fair?

Ms. DISNEY. No, I am not worth half a billion dollars.

Mr. DUFFY. Then the news reports might be wrong.

Ms. Gilbert?

Ms. DISNEY. Oh, they are so wrong.

Mr. DUFFY. Ms. Gilbert?

Ms. GILBERT. The owners of my firm are fully aware of my compensation, and that is what we are asking of publicly traded companies.

Mr. DUFFY. So you don't want to share that here. Okay.

Mr. Copland?

Mr. COPLAND. I am not going to tell you.

Mr. DUFFY. Interesting.

Ms. Disney, so obviously you have incredible wealth. I would imagine that you probably have—

Ms. DISNEY. Dr. Disney, thank you.

Mr. DUFFY. What is that?

Ms. DISNEY. Dr. Disney.

Mr. DUFFY. Dr. Disney, yes. Do you have people who work for you in your home?

Ms. DISNEY. Yes.

Mr. DUFFY. Someone who maybe cleans your home?

Ms. DISNEY. Yes.

Mr. DUFFY. Maybe cares for your pets?

Ms. DISNEY. Yes.

Mr. DUFFY. How much do you pay them? At the lowest level, the lowest-paid employee.

Ms. DISNEY. Something in the range of $75,000 a year, something like that.

Mr. DUFFY. So you are making $6 million and you are paying $75,000. And that is the lowest salary that you give someone in your home?

Ms. DISNEY. I think so, yes.

Mr. DUFFY. Okay.

Ms. DISNEY. Yes. Do you think that is an unfair wage to pay a domestic worker?

Mr. DUFFY. I don't know. You tell me. In San Francisco, it may be.

Ms. DISNEY. I will tell you that it is the highest I have ever—

Mr. DUFFY. For the record, I would note that it is fascinating we want disclosures, but in our unions, we are unwilling to disclose the amount that we make.

Chairwoman MALONEY. Excuse me, the gentleman's time has expired.

Mr. DUFFY. I find it troubling.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. DUFFY. And I will yield back.

Chairwoman MALONEY. The gentlewoman from Iowa, Mrs. Axne, is recognized for 5 minutes.

Mrs. AXNE. Thank you, Madam Chairwoman. I have heard a lot of discussion today about the burden that these disclosures could put on companies, and let's be very clear, companies are already looking at this information. And the ones who are operating the best are using this to their full advantage, and that is for their investors, their stockholders, and their employees. I spent 18 years of my career working on many of these same issues in public companies, as well as State Government. And companies are already tracking these metrics, the majority of the metrics that we are actually asking for.

This bill is all about balancing a company's incentives to maximize short-term profits with the need to reinvest in their workforce and their company for the long-term. I know it works. Our top business schools know it works, which is why they offer and promote majors in human capital management and organizational development. I hope all of my colleagues believe that business schools, like my alma mater, Northwestern's Kellogg School of Management, aren't selling our businesses a bill of goods. Because I don't think they are. They are promoting these studies because they benefit businesses. And research shows that how you manage your people has long-term effects on profitability.

So, Mr. Copland, you said in your testimony that there is little reason to believe that such disclosures are material to a profit-maximizing investor. I think SEC Chairman Clayton might disagree, as he has indicated several times that he would like to see more disclosure on human capital management.

And then, I also have research from Lancaster University showing that U.S. companies that disclose their investment in human capital have outperformed those who don't.

And so, I would like to ask you, Ms. Gilbert, as a portfolio manager, can you explain how these disclosures will help you maximize returns on your fund?

Ms. GILBERT. I would like to point to some of the specific items that have been requested. Coming back to the disclosure, for example, around workforce diversity that has been discussed during the hearing already, as a portfolio manager, we think about how this information can help to drive business success. And we believe when it comes to workforce diversity, that having different voices around the table helps to drive strategy in a significant way.

I have completed studies that focus on this issue. For example, with regard to board diversity, because that data is available, as Mr. Copland mentioned, but there is no reason to think that that wouldn't drive success at the level of the team.

Another data item, for example, that has been discussed is compensation. When I have studied compensation issues for corporations, I actually think about it as an investor, as an issue of leadership signaling. There are, essentially, agency issues that can arise between a company's CEO and board, and the shareholders of the firm, where we want to be sure that they are maximizing the benefits of all stakeholders, including the shareholders relative to themselves. One way that we can measure this is how they are compensating themselves relative to others in the company. So those are just a couple of examples of how we believe that we can use human capital management data to be better, more successful investors.

Mrs. AXNE. Thank you, Ms. Gilbert.

Moving on, I want to make sure I thank Senator Peters for the work he has done on the Outsourcing Accountability Act. I appreciate all the feedback that my colleagues have given today on this legislation, and I look forward to working with everyone on both sides of the aisle on these bills.

Ms. Corzo, would you say that the public has accurate information about where public companies are creating jobs?

Ms. CORZO. No.

Mrs. AXNE. Okay. And would you say this bill would provide information and make it more likely that we would invest in American jobs?

Ms. CORZO. I think so. I think information is critically important here. I think that for two reasons, actually. The first is that what gets measured, gets paid attention to, within a company. And so the process of reporting itself will force the folks, at the senior-most levels within the firm, to look at the data. And then they will also have to think about what is going to happen on their quarterly earnings calls with analysts, and what the questions will be that they will be asked. And so, I think that the process of disclosing that information, of preparing the disclosures and thinking about how it is going to be communicated, will help to impact the behavior. I don't think it is the single silver bullet that will solve the problem, but I do think it will be helpful.

Mrs. AXNE. Thank you. And I have 20 seconds left, about. I would just like to impress on my colleagues the importance of moving forward these bills. In particular, as we continue to build a knowledge-based economy, it is incredibly important to value that asset, and we are overlooking that in many ways, and this will help with it. Thank you.

Chairwoman MALONEY. The gentleman from Illinois, Mr. Casten, is recognized for 5 minutes.

Mr. CASTEN. Thank you, Madam Chairwoman.

Mr. Copland, a couple of quick questions. What percent of U.S. equities are held by foreigners?

Mr. COPLAND. I am not certain. I could get back to the committee on it.

Mr. CASTEN. Does anybody else on the panel know the answer to that question? In terms of the total capital in U.S. companies' equity, and that it is about 30 percent. Given that, when we give a dollar of money from the U.S. Treasury to corporations in the form of a tax cut, Mr. Copland, and they use that for stock buybacks or paying down dividends, what percentage leaves the country?

Mr. COPLAND. I would question the premise that a tax cut is a gift away of a dollar. But clearly, if 30 percent of the owners are foreign, then 30 percent of the beneficiaries would be foreign.

Mr. CASTEN. Okay. I wanted to make that point, because your comment that share buybacks are good for U.S. companies presumes that only Americans own U.S. companies, and it simply isn't true, and those trends are increasing.

Mr. Clifford, in your piece in The Atlantic, you had mentioned that a CEO provides guidance and oversight, but it is the typical employee who is actually the one producing a good or service. Can you talk a little bit about why it is that over 2 decades of productivity growth, the gains from productivity growth have overwhelmingly gone to the executive suite, while medium wages have stayed basically stagnant?

Mr. CLIFFORD. It is very simple. The boards have adopted a certain way of paying CEOs. As I said, it is a very complicated system, but it starts with, you assemble a peer group. There are always other very highly paid CEOs. Then your board pegs you at the 75th percentile of that peer group. I have never seen anybody paid below the 50th percentile. Then you have a series of bonus targets, and if you surpass those bonus targets, you make more than the 75th percentile. So you end up, you know, you are in a pretty good negotiating position. You have all the information as CEO. So you end up making probably 2½ times your target.

Now, here is the beauty of that. That then goes back into the peer group of all your other peers. They get a raise next year just because you get a raise. You get a raise the year after because they got a raise. So you have this system that, with mathematical certainty, produces 10 percent increases in CEO pay.

Now, this works only at the CEO level. They would never apply this cockamamie system to anybody else. Everybody else gets 4 percent, and because they are all using the system, the CEO gets 10 percent, 12 percent, year after year. And you just turn the cranks, and the 12 percent shoots right out. That is why you have it.

Mr. CASTEN. Thank you.

Moving to Ms. Gilbert, there has been this long shift towards shareholder capitalism and aligning compensation with equity performance, and that is not without its merits. It certainly keeps people aligned. But most of my career was as a CEO. So I am familiar with how these things can be gamed, particularly when you have options that are—with strike prices below the listing price of the stock. The CEO, as you all know, has essentially a one-way bet,

and they don't share any of the downside exposure that the investors have, but have tons of upside potential.

Can you help us quantify how prevalent that trend is, and in your capacity, in your role, how might we either fix that from a board governance perspective, or in the absence of leadership from a board governance, from a regulatory perspective that this committee would have jurisdiction over?

Ms. GILBERT. I am sorry to say that I haven't had the chance to study this in detail, so can't quantify for you the prevalence. But with regard to strategies for changing the patterns around shareholder primacy, one important focus would be to begin to find ways to train capital markets, shareholders, and leaders, to focus on longer-term goals, longer-term performance. And this can be built directly into the compensation plans themselves.

Part of the problem that you are describing, you talk about the option, it is not just the strike price that is part of the option. It is also the time horizon, as you know. So I believe that if we are able to train our goals on longer-term issues, longer-term focus, that it would change all of the other behaviors underneath.

Mr. CASTEN. Thank you. I yield back my time.

Chairwoman MALONEY. The gentlewoman from New York, Ms. Ocasio-Cortez, is recognized for 5 minutes.

Ms. OCASIO-CORTEZ. Thank you, Madam Chairwoman, and thank you for holding this extremely important hearing. Thank you all to all of our witnesses here today. It is so important that we talk about some of these issues.

So, folks consistently bring up this term stock buyback—stock buyback, stock buyback. But a lot of folks don't really understand what this really means. So let's break it down.

Ms. Corzo, let's say I am the CEO of a major corporation. Let's say I am the CEO of a big pharmaceutical company, or a big retailer like Toys "R" Us or Sears, a company that is big enough and developed to the point where it can be traded on the stock market. So you can buy and sell shares of Toys "R" Us or Merck or what have you. My first question is, is it common for CEOs to have their pay tied to stock price?

Ms. CORZO. Absolutely. And as Mr. Clifford was just explaining, that is typical and when—typical supply and demand. Right? When you buy stock, the supply goes down, the price goes up. And then a lot of the metrics that go into the calculation help increase the pay.

Ms. OCASIO-CORTEZ. So it is exceedingly common for CEOs of these major corporations to have their pay tied to the stock price. So, great. So I am the CEO, my compensation package is based on the performance of the stock price. And I think it is fair to say that that means I am incentivized to make that stock price as high as possible, right? If I want a huge payday, I need to make sure that this stock price on the Dow Jones, on the Nasdaq, is as sky high as possible. And to clarify, stock price doesn't always immediately or directly correlate to the actually value of the product that I am selling, correct? So it is not as though my product is getting more valuable if the stock price increases, right?

Ms. CORZO. Right.

Ms. OCASIO-CORTEZ. Okay. Good to know. And it generally can create a situation where it prioritizes the interest of the shareholders more than the actual consumers of the product, or even the employees of the company.

Ms. CORZO. Absolutely.

Ms. OCASIO-CORTEZ. All right. So let's say I am, again, the CEO. I am ruthfully incentivized to make sure that we get the stock price as high as possible. And usually that means just increasing profit for shareholders. So I need to find a way to build this margin. So let's say I take away healthcare from my workers, right? I can make a huge killing making sure that we don't pay for anybody's healthcare. Let's take their insurance away. Or, let's just say, hypothetically, I get a slew of hired-gun lobbyists to buy up Members of Congress to secure the largest tax cut in the history of the United States, so I get a big chunk from that.

So now, okay, I have that money. Let me take my CEO hat off. But in real life, my dad ran a small business. And whenever we had a good year in the small business, we tried to pay our secretaries more, or we tried to invest more in things for the business. But as the CEO of a major company, I can take that money, and I don't have to do that at all, right? I can actually have the company buy its own stock on the market, right?

Ms. CORZO. Yes.

Ms. OCASIO-CORTEZ. So let's say if I am a big pharma CEO, I can go, take this money, take people's healthcare away, take that margin and buy my own stock on the Nasdaq, and that would effectively increase the stock price, right?

Ms. CORZO. Yes.

Ms. OCASIO-CORTEZ. And I have done nothing to change my company, I have done nothing to make my product more valuable, my employees more happy. I haven't invested in the training or the workforce to make the company inherently more valuable, but I have inflated the stock price, right?

Ms. CORZO. Absolutely, right.

Ms. OCASIO-CORTEZ. So my question is, how is this different from a pyramid scheme?

Ms. CORZO. No, it is—that is a very good question. It is a concern that I think a lot of people talk about when we talk about financialization. This is the concept that we are seeing so much in our economy. When there is a lot of effort going into driving up stock prices, driving up the value of financial assets, that does nothing for the real economy.

Ms. OCASIO-CORTEZ. And I think that has an additional expense, because when you look at, for example, the GOP tax scam, about 60 percent of all of those proceeds went to stock buybacks, and now today, we are being told that GDP is at an all-time high, but GDP tends to be indicators of company and corporate value. Is that correct?

Ms. CORZO. Yes.

Ms. OCASIO-CORTEZ. So it is possible that our GDP numbers are going up without any actual value added to our economy, is that correct?

Ms. CORZO. That is correct.

Ms. OCASIO-CORTEZ. All right. Well, that is concerning.

Dr. Disney, just one last question. You, again, you are—my mistake. Your grandfather was the co-founder of the Walt Disney Company, correct?

Ms. DISNEY. Yes.

Ms. OCASIO-CORTEZ. And as you indicated earlier, the CEO was paid $65.6 million, even though the median salary is $46,000. Do you agree with that?

Ms. DISNEY. Yes.

Chairwoman MALONEY. The gentlewoman's time has expired.

Ms. OCASIO-CORTEZ. Thank you, Madam Chairwoman.

Chairwoman MALONEY. The gentleman from Illinois, Mr. Garcia, is recognized for 5 minutes.

Mr. GARCIA OF ILLINOIS. Thank you, Madam Chairwoman. And I would like to thank all of the witnesses who have testified this morning.

Some questions for the panel. Ms. Corzo, you mentioned in your testimony the problems that buybacks at Walmart and General Electric have caused the workers at those companies. Of course, it isn't just those companies that have spent their funds or buybacks rather than in jobs and growth. Earlier this year, Joe Olson, an AT&T employee, testified before the Senate that the company has spent $16.5 billion on buybacks since 2013, and spent more on buybacks last year than it has in several years, even as AT&T has cut 23,000 jobs.

Since the passage of the Corporate Tax Act, AT&T has laid off 2,300 call center workers in the Upper Midwest, where I am from, alone. So it seems like these problems are widespread across corporate America. In that context, should this committee consider eliminating the safe harbor that currently exists for stock buybacks, as proposed in Senator Baldwin's Reward Work Act?

Ms. CORZO. Yes. The AFL-CIO and Americans for Financial Reform have both endorsed that bill. And I would add that one of the things that is particularly attractive is that it puts workers on board, in addition to addressing the stock buybacks.

Mr. GARCIA OF ILLINOIS. Upon introducing the Reward Work Act earlier this year, Senator Baldwin, her staff issued a report that found that, "Buybacks suppress wages, drive income and wealth inequality, decrease investment, increase systemic risk, harm retirement savers, and jeopardize capital formation by allowing speculators to extract value from public companies." I ask for unanimous consent to enter this staff report into the record.

Chairwoman MALONEY. Without objection, it is so ordered.

Mr. GARCIA OF ILLINOIS. Thank you. One powerful example of this extraction cited in the report is the case of activist investor Carl Icahn, who purchased 3.4 billion shares in 2013 and 2014, and from other shareholders, then successfully demanded that Apple accelerate its stock buybacks again, selling his newly, more valuable shares at a $2 billion profit. As the report notes, "Apple calls its buyback program, the Capital Return Program," yet the company isn't returning cash to shareholders like Icahn, because they haven't given the company anything. Icahn sold his Apple shares after holding them for 32 months, for a $2 billion gain. This example illustrates how activist investors use stock markets to take cash out of company, rather than supply companies cash to put to pro-

ductive use, rewarding the wealth of the activist, not the work of the employee who generated the profits in the first place.

Ms. Corzo, can you comment on how common examples of extractive behavior like Icahn's are?

Ms. CORZO. Unfortunately, I am not able to quantify that, but it is very commonplace. It is a common strategy that we see among private funds quite a bit. We hear a lot from private fund managers that the reason that they make so much money is because they have some sort of special miracle way of getting into a business and finding the way to drive value creation, when in reality, a lot of what we are seeing is wealth extraction. And there is an important difference, because value creation is what makes our economy profitable in the long-term, what drives real economic growth that helps all members of our society to live better lives, whereas value extraction only benefits those at the very top. And that is a lot of the type the strategy that we are seeing from these activists investors, which are typically hedge funds.

Mr. GARCIA OF ILLINOIS. And in my 30 seconds that are left, I want to ask you, is it, in your opinion, in the long-term interest of pension funds and other investors that are supposed to look out for the long-term interests of workers and other investors that they represent to engage in this?

Ms. CORZO. Absolutely not. A pension fund is looking out for returns not just today, but 40, 50 years from now. We need to provide further time and security of our members, corporate strategies that will drive profitability over decades to come, not just the next quarter.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. GARCIA OF ILLINOIS. Thank you, Madam Chairwoman.

Chairwoman MALONEY. The gentleman from Minnesota, Mr. Phillips, is recognized for 5 minutes.

Mr. PHILLIPS. Thank you, Madam Chairwoman. And thanks for the invitation to join this subcommittee hearing today, and to our witnesses.

In the spirit of full disclosure, I am a capitalist, an entrepreneur, a recovering CEO myself, someone who has co-owned two consumer brands that I think most Americans are quite familiar with, and also someone who believes that business can and should be a means to an end. The end should not be the aggregation, rather the sharing with the people and the communities that make success possible.

So that is why I believe that wealth and income disparities are a great threat to our country. And recognizing the data, the real average wage in this country is about the same as it was 40 years ago. In 1965, the average CEO-to-employee compensation ratio was 20-to-1. Now it is 312-to-1.

Which would mean that my fellow Members of Congress and I would each be making $18 million right now if we applied the same ratio. I would love to know what American citizens would think of that number. I hazard a guess.

My first question, though, to each of you is a simple one, and just a yes-or-no answer. Do you believe that growing wealth and income disparities pose an economic and social risk to our country?

Mr. Clifford?

Mr. CLIFFORD. Yes.

Ms. CORZO. Yes.

Ms. DISNEY. Yes.

Ms. GILBERT. Yes.

Mr. COPLAND. No and yes, depending on which question you are talking about. Economic, no; social, yes.

Mr. PHILLIPS. Economic, no, and social, yes.

Mr. COPLAND. Economic, no; social, yes.

Mr. PHILLIPS. So, Mr. Copland, you might know, in your opening remarks, you mentioned that the propositions that we are considering may well retard economic growth in the United States of America.

My bill is a very simple one, the Greater Accountability in Pay Act. It is all about transparency. So let me know, how does transparency pose an economic threat to the United States of America?

Mr. COPLAND. Because you are asking the wrong question with the wrong metric. And, therefore, you are going to have, exactly as I discussed earlier in the hearing, you are going to have situations where a company that contracts out is going to have very different ratios than a company that has workers in-house.

So the actual ratio you are talking about—and we have seen the same thing with the aggregate static pay ratio bill that was added in the Dodd-Frank Act, the rule that was promulgated after that. But what you are talking about is going to exacerbate that, because you are actually talking about raises, you are talking about year-over-year changes. And those are going to fluctuate widely at the top due to the equity compensation that institutional investors have driven on corporate boards.

Mr. PHILLIPS. Then let me than ask you a follow-up question. What do you believe, what thoughtful policies should we be considering to provide incentives to American corporations, public and private, to share more with their employees, the people who make success possible?

Mr. COPLAND. I don't think that is a useful strategy for economic growth, is the answer, because—

Mr. PHILLIPS. Let me just clarify. So sharing more is not a recipe for economic growth?

Mr. COPLAND. Paying workers more than the marginal utility of their labor is not a strategy for a business to grow. And ultimately what you will be doing is, if you are overpaying your workers more than their marginal productivity of labor, you are going to be losing business to foreign competitors or to other competitors not subject to that rule.

Mr. PHILLIPS. And that is not my—my question is incentives for businesses, public and private, to share more. What policy should—

Mr. COPLAND. "Share" is a very nebulous term there.

Mr. PHILLIPS. Okay.

Mr. COPLAND. But if what you are talking about is driving up employee compensation relative to marginal productivity of labor, relative to what is paid in a competitive labor market, then you are driving down the competitiveness of the company, which is in the longrun going to retard the economic growth of the country.

Mr. PHILLIPS. So your argument is that the status quo is in the best interest of the future of the country?

Mr. COPLAND. I am not saying the status quo. I have criticized the status quo a lot of times. But I think what you are proposing is to go in the exact wrong direction.

Mr. PHILLIPS. Okay. Simply exposing the increase in pay amongst executives at a public corporation with those of their own employees, that is—that is not just—

Mr. COPLAND. Well, it is fine.

Mr. PHILLIPS. Okay.

Mr. COPLAND It is just not just a useful metric that is material to investment.

Mr. PHILLIPS. Okay.

Do any other witnesses here today have any thoughts on what we should be considering to provide incentives to share more with employees?

Ms. DISNEY. I would just love to just spend a minute with the idea of the marginal utility of labor.

We have been talking in parallel lines about this whole thing. We have been talking about what investors need and then, in a completely separate way, talking about what workers need. And these should not be separate and independent issues.

We need to restructure what we measure and what we understand about the purpose of business and the purpose of an economy so that labor's interests are not inherently in conflict with what investors need.

So the marginal utility of a toilet being scrubbed, I would argue, is actually high. You can't run your business without that. And to make a person work 8 to 10 to 12 hours a day scrubbing toilets and ask them to go home with not enough money to feed their families is just on its face a ridiculous way for an economy to be structured.

Mr. PHILLIPS. I agree. And thank you, Dr. Disney.

I yield back.

Chairwoman MALONEY. The gentleman's time has expired.

Before we wrap up, I would like to take care of one administrative matter.

Without objection, I would like to submit letters and statements to the record from the Council of Institutional Investors; from Public Citizen; from Dr. Anthony Hesketh; from a group of academics, including Lori Foster, Dan Ariely, and David van Adelsberg; and an article by Mr. Hill from Arkansas.

And I would like to thank our witnesses for their testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is now adjourned. Thank you.

[Whereupon, at 12:08 p.m., the hearing was adjourned.]

A P P E N D I X

May 15, 2019

THE NEED TO REFORM CEO PAY

By Steven Clifford

Steven Clifford is the author of *The CEO Pay Machine.* He served as CEO for King Broadcasting Company from 1987 to 1992 and National Mobile Television from 1992 to 2000.

He has been a director of thirteen public and private companies. He holds a BA from Columbia University and an MBA with Distinction from Harvard Business School.

I was a CEO for 14 years and have served on thirteen corporate boards. A few of these boards asked me to chair the compensation committee. These were not S&P 500 companies, but hired the same executive compensation consultants and used the same CEO pay system as the larger companies.

As I saw this pay system at work I began to think it didn't make sense. It overpaid the CEO but that was a minor problem. Worse, the annual bonuses created perverse incentives and pushed the CEO in wrong directions. They compelled a short-term focus.

Bonuses motivated the CEO to concentrate on the metrics that generate the bonus. But at the same time bonuses limited curiosity, creativity, and innovation, and pleasure in a job well done — the very things that make people perform at their best.

To convince my fellow board members to throw out this pay system, I began to do research. I concluded that this CEO pay system harms the companies that use it, impedes economic growth and is a principal driver of rising income inequality.

I believe in free markets and capitalism with a light regulatory touch to assure free markets. I hold that this is the best economic system known today. I criticize CEO pay because it has nothing to do with free markets and is a threat to robust capitalist economy. This system enriches the insiders who manage it — corporate executives, board members and executive compensation consultants. It swindles everyone else.

American corporations celebrate free markets, but dismiss them when paying CEOs.[1] To set CEO compensation, Corporate America applies a rigged, opaque, and self-serving internal method that has nothing to do with supply and demand.

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[1]In this paper, "CEOs" refers to the CEOs of the S&P 500, the 500 largest publicly traded companies in America, or the nearly identical Fortune 500.

CEO pay averaged $18.9 million in 2017, a 17.6% increase over 2016.[2] But athletes and movie stars also make a lot of money. Why pick on CEOs?

Because the market sets compensation for athletes and movie stars but not for CEOs. Teams and movie studios bid for athletes and movie stars because their skills are portable. LeBron James would improve any NBA team and Meryl Streep any movie.

Most CEOs would not improve another company because their competence rests on knowledge of a single company — its finances, products, personnel, culture, competitors, etc. — and a single industry. Such knowledge and skills are best gained working within the company; they are not worth much outside the company.

Corporate boards understand this. Three-quarters of corporate directors believe internal candidates are better than external ones.[3] Internal promotions account for three-quarters of all new CEOs.[4] Moreover, CEOs hired from the outside are twice as likely to be fired as opposed to internal promotions.[5]

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[2] Lawrence Mishel and Jessica Schieder, "CEO Compensation Surged in 2017," Economic Policy Institute, August 16, 2018, https://www.epi.org/publication/ceo-compensation-surged-in-2017/.

This study included gains on the exercise of stock options in CEO pay. Were these excluded, CEO pay would have averaged $13.3 million.

[3] Dale S. Rose, "Five Essential Questions for Getting CEO Succession Right (#2)," *Leadership Insight* (blog), February 16, 2012, http://leadershipinsightblog.com/2012/02/16/getting-ceo-succession-right-2/.

[4] Kevin J. Murphy and Ján Zábojník, "Managerial Capital and the Market for CEOs" (working paper, April 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984376.

[5] William G. Hardin III and Gregory Leo Nagel, "The Transferability of CEO Skills" (working paper, October 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019413.

For all these reasons, companies rarely bid for an outside CEO. Less than 2% of Fortune 500 CEOs were previously a public company CEO.[6] CEO jumps between large companies happen about once a year.[7] And when they jump, they usually fail; outside hires are twice as likely to be fired than internal promotions.[8]

Without an auction market to guide them, almost all large companies have adopted the rigged CEO pay system developed by compensation consultants. The practices embedded in the system display a superficial logic, but in combination guarantee runaway CEO pay.

The first step is to select a peer group of supposedly comparable companies and then base pay on what these companies pay their CEOs.

You will be shocked to learn that firms select peers with highly paid CEOs. Researchers have found that "compensation committees seem to be endorsing compensation peer groups that include companies with higher CEO compensation, everything else equal, possibly because such peer companies enable justification of the high level of their CEO pay."[9] Another study noted "significant structural bias in the

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[6] Martijn Cremers and Yaniv Grinstein, "Does the Market for CEO Talent Explain Controversial CEO Pay Practices?," May 21, 2013, *Review of Finance* (forthcoming), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108761.

[7] C. Edward Fee and Charles J. Hadlock, "Raids, Rewards, and Reputations in the Market for Managerial Talent," *The Review of Financial Studies* 16, no. 4 (Winter 2003), http://rfs.oxfordjournals.org/content/16/4/1315.

[8] Gretchen Morgenson, "C.E.O.'s and the Pay-'Em-or-Lose-'Em Myth," *New York Times*, September 22, 2012, http://www.nytimes.com/2012/09/23/business/ceos-and-the-pay-em-or-lose-em-myth-fair-game.html?pagewanted=all&_r=0.

[9] Michael Faulkender and Jun Yang, "Inside the Black Box: The Role and Composition of Compensation Peer Groups," *Journal of Financial Economics* 96, no. 2 (May 2010), http://www.sciencedirect.com/science/journal/0304405X/96/2.

selection of compensation peers."[10] Consider the peer group for UnitedHealth Group when its CEO was the highest paid in the United States. This peer group included American Express, Apple, Bank of America, Cisco, Citigroup, Coca-Cola, Costco, Dow Chemical, General Electric, Goldman Sachs, and Google, and we are only one-quarter of the way through the alphabet.

Before joining UnitedHealth Group, this CEO had worked only at one accounting firm. With no applicable industry experience, American Express, Apple, Bank of America, Cisco, and the rest would never consider hiring him as CEO. Whatever these so-called peers paid their CEOs is totally irrelevant.

American companies virtually never include foreign companies, even their fiercest competitors, in their peer groups, as this would dramatically lower CEO pay.[11] The high level of CEO pay in America is not a consequence of a modern, globalized economy. Other advanced economies function without bestowing vast wealth on CEOs.

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[10] "Compensation Peer Groups at Companies with High Pay," IRRC Institute, June 2010, http://www.irrcinstitute.org/pdf/Final-Compensation-Peer-Groups-at-Companies-with-High-Pay_June2010.pdf.

[11] Tellingly, when companies compare performance against others, they almost always ignore their carefully selected peer group. Instead, they use a broad market index or some internally prepared bogey that they almost always exceed. Weighted for market capitalization.

In America, the ratio of CEO-to-average-worker pay (CEO pay ratio) is 312 to 1.[12] In Japan it is 16 to 1.[13] It's 48 to 1 in Denmark.[14]

The adoption of peer groups was driven neither by a coherent theory, nor a compelling philosophy, nor demonstrable effectiveness. It was blessed neither by academic studies nor industry conferences. It did not reduce costs. It increased them. Why did the use of peer groups to set CEO pay quickly achieve ubiquity? Because CEOs and boards saw it was in their self-interest. CEOs got more money and boards could hide behind supposedly objective data assembled by third-party experts.

Having selected a group of highly paid peers, the next step is to rank the CEO within the group, on the theory that excellent companies should pay more than lousy companies. Apparently, directors assume that any company that would invite them on the board must be first-class. Every board on which I've served or researched ranked itself, and therefore its CEO, at the 50th, 75th, or 90th percentile of the group.[15] Rankings

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[12] Mishel and Schieder, "CEO Compensation Surged."

[13] Zaid Jilani, "Average Japanese CEO Earns One-Sixth as Much as American CEOs," ThinkProgress, July 8, 2010, http://thinkprogress.org/politics/2010/07/08/106536/japanese-ceo-american-sixth/.

[14] Gretchen Gavett,"CEOs Get Paid Too Much, According to Pretty Much Everyone in the World," *Harvard Business Review*, September 23, 2014, https://hbr.org/2014/09/ceos-get-paid-too-much-according-to-pretty-much-everyone-in-the-world/.

[15] At the 50th percentile benchmark, the compensation is higher than half the peer group CEOs and lower than half. At the 75th percentile, the compensation is higher than three-quarters of the CEOs in the peer group.

below the 50th percentile almost never occur.[16] The net result of such ranking is a corporate Lake Wobegon where all CEOs are above average.

CEOs need not achieve anything to be benchmarked at the 75th percentile. The highest paid CEOs in 2010, 2011, 2012, 2013, and 2014 did not, and did not have to, perform better than 75% of their peer group; they were pegged at the 75th percentile based upon the board's presumption that they were a swell company.[17]

While peer groups and benchmarks are the foundation of the pay system, they produce only a *target* for CEO compensation. This target is then transformed into actual compensation by applying bonus metrics and bonus ranges. Typically these are a set of metrics, such as earnings-per-share (EPS), cash flow, beating a budget, or total shareholder return. In any given year, a CEO may receive multiple short-term and long-term bonuses, most with a range between the maximum and minimum bonus, a complex, and at times, divergent set of performance criteria.

The CEO is well positioned to negotiate easy bonus arrangements as he controls the company's information and planning systems, while the board, lacking staff and institutional memory, gets most of their information through the CEO.[18] Even if he misses targets, he runs the books and exercises accounting discretion to increase earnings.

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[16] Thomas A. DiPrete, Gregory M. Eirich, and Matthew Pittinsky, "Compensation Benchmarking, Leapfrogs, and the Surge in Executive Pay," *American Journal of Sociology* 115, no. 6 (May 2010), http://www.jstor.org/stable/10.1086/652297.

[17] Steven Clifford, *The CEO Pay Machine: How It Trashes America and How to Stop It* (New York: Blue Rider Press, 2017), 118–154.

[18]Avoiding the awkward repetition of "he or she," I will use the male pronoun when referring to CEOs since 95% are men.

A CEO who beats performance goals may make two to three times his target compensation. And they often do. For example, the highest paid CEOs in 2010 and 2011 had compensation targets of $9.1 and $20 million and actual compensation of $102 and $145 million.[19]

Such enormous CEO paydays are then fed back into the peer groups for other CEOs, increasing their compensation. In turn, their higher numbers get fed back into the first CEO's peer group generating still another increase. Since 1978, these annual rounds of CEO leapfrog have produced a 1,000% inflation-adjusted increase in CEO pay. During the same period, the median real wage for American males has declined.[20]And the CEO pay ratio has grown from 26 to 312.[21] America's most respected institution, the U.S. military, functions effectively with a CEO pay ratio of less than five.

Businesses are supposed to control expenses. CEO pay is one of the few that the board directly manages. Why don't they ignore what others pay CEOs and ask if another company is likely to bid for his services? If no one else is interested, why give more than the percentage increase that most other employees receive? In the unlikely case that

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[19] Clifford, *The CEO Pay Machine*, 118–154.

[20] U.S. Bureau of Labor Statistics, Employed full time: Median usual weekly real earnings: Wage and salary workers: 16 years and over: Men [LES1252881900Q], retrieved from FRED, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/LES1252881900Q.

[21] CEO pay ratio 26.
Bonnie Kavoussi, "CEO Pay Grew 127 Times Faster than Worker Pay Over Last 30 Years: Study," *Huffington Post*, May, 2, 2012, http://www.huffingtonpost.com/2012/05/02/ceo-pay-worker-pay_n_1471685.html.

CEO pay ratio 312.
Mishel and Schieder, "CEO Compensation Surged."

another company may pursue him, the board can apply cost/benefit analysis by weighing the odds and cost of his leaving against the additional pay to keep him. This is a simple task compared to many complex business decisions.

Directors don't control CEO pay because it is not in their self-interest.

The board wants to keep the CEO happy. He is the captain of the team, is often their friend, and may have invited them to join the board. Other CEOs and ex-CEOs usually constitute a majority of the board.

The CEO negotiates for himself while the directors negotiate for the shareholders. The CEO pockets what he gets, but the directors pay with the shareholders' money, not their own, a recipe for an uneven negotiation.

Director and CEO compensation are highly correlated and typically influenced by the same compensation consultant. With annual director fees averaging $288,909 why balk at a big raise for the CEO? You are likely to get one yourself next year. And you won't be asked to join other boards if the word gets out that you are tough on CEO pay.

Directors have scant incentive to rock the boat and disturb board congeniality by resisting CEO pay increases, especially when they can hide behind supposedly impartial third-party consultants. Though a vocal critic of CEO pay levels, even Warren Buffett admitted that he has voted for compensation plans with which he disagreed.[22]

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[22] Joe Nocera, "Buffett Punts on Pay," The Opinion Pages, *New York Times*, April 25, 2014, http://www.nytimes.com/2014/04/26/opinion/nocera-buffett-punts-on-pay.html.

Directors know they cannot be personally liable no matter how much they pay the CEO. The "business judgment rule" gives the board broad discretion.[23] Then there is safety in numbers. Directors can reassure themselves that they are doing precisely what all other boards do, and even rationalize that the profligacy of those other boards created this problem. Those boards acted irresponsibly, established ridiculous CEO pay levels, and left us with no choice but to match them.

Directors would deny that they are shills for the CEO and explain that the big bucks serve as "motivation" and are justified by "pay for performance." There is no evidence to support these claims.

CEOs are intrinsically highly motivated people. This is how they got the job. The pay system can only channel this motivation. Today's system misdirects it toward short-term achievements instead of long-term growth and shareholder satisfaction.

At the CEO level, not only are immense bonuses unnecessary, they are counter-productive. "There is no evidence that massive financial incentives attract the best talent," says one expert on this issue. "[They] fill up your entire thinking space, preventing you from focusing on other things or being open to ideas."[24] Other research confirms that while financial incentives can be effective for simple, repetitive tasks, they

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[23] Board decisions on the size and structure of executive compensation deserve "great deference by the courts." Brehm v. Eisner, Delaware Supreme Court, 746 A.2d 244, 262-263 (2000).

[24] Ruth Sullivan, "Excessive Executive Pay 'Bad for Business,'" *Financial Times*, June 3, 2013, http://www.theglobeandmail.com/report-on-business/careers/excessive-executive-pay-bad-for-business/article12029730/.

tend to decrease motivation and performance for complex jobs such as managing a large company.[25]

Though bonuses are useless or perverse as a motivational tool, corporations are still wedded to the concept of "pay for performance." According to most company proxy statements, this is the first principle of executive compensation. But they have never been able to make "pay for performance" work. Over long periods, the more a company pays

[25] *See* Edward L. Deci, Richard Koestner, and Richard M. Ryan, "A Meta-analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation," *Psychological Bulletin* 125, no. 6 (November 1999), http://psycnet.apa.org/journals/bul/125/6/627 and Alfie Kohn, "Why Incentive Plans Cannot Work," *Harvard Business Review*, September–October 1993, https://hbr.org/1993/09/why-incentive-plans-cannot-work.

its CEO, the worse shareholders fare.[26] Companies that overpay their CEOs are usually poor investments. This is confirmed by many recent studies.[27]

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[26] Professors Michael J. Cooper of the University of Utah, Huseyin Gulen of Purdue University, and P. Raghavendra Rau of the University of Cambridge examined the relationship between CEO pay and stock performance at the 1,500 companies with the largest market capitalization. In the three-year periods from 1994–2013, they found the more CEOs got paid, the worse their companies did.

The top 10% of CEOs in pay returned 10% less to their shareholders than did their industry peers. While these CEOs were paid an average of $21 million a year, the shareholders of these companies received $1.4 billion less than comparable companies with lower paid CEOs. The more CEOs were paid, the worse they performed. The companies in the top 5% in CEO pay did 15% worse, on average, than their peers.

The study also found that the longer CEOs were in place, the worse their firms performed. Cooper says this is because those CEOs are able to appoint more allies to their boards, and those board members are likely to go along with the bosses' bad decisions. "For the high-pay CEOs, with high overconfidence and high tenure, the effects are just crazy," he says. They return 22% worse in shareholder value over three years as compared to their peers."

Susan Adams, "The Highest-Paid CEOs Are The Worst Performers, New Study Says," June 16, 2014, https://www.forbes.com/sites/susanadams/2014/06/16/the-highest-paid-ceos-are-the-worst-performers-new-study-says/#6db264cc7e32.

[27] CEO Pay and Company Performance

- "Companies that awarded their Chief Executive Officers (CEOs) higher equity incentives had below-median returns based on a sample of 429 large-cap U.S. companies observed from 2006 to 2015. On a 10-year cumulative basis, total shareholder returns of those companies whose total summary pay (the level that must be disclosed in the summary tables of proxy statements) was *below* their sector median *outperformed* those companies where pay *exceeded* the sector median by as much as 39%." "Has CEO pay reflected long-term stock performance?" the author asked. His answer was, "In a word, 'no.'"

Ric Marshall and Linda-Eling Lee, "Are CEOs Paid for Performance?" MSCI ESG Research Inc., July 2016, https://www.msci.com/documents/10199/91a7f92b-d4ba-4d29-ae5f-8022f9bb944d.

- An MSCI study of 423 companies found CEO equity awards to be negatively correlated with performance. The lowest fifth in CEO equity awards outperformed the top fifth by nearly 39% on average on a 10-year cumulative basis.

Why does outsize CEO pay lead to poor performance? The millions that companies waste on executive pay is a small part of the cost. In addition, colossal CEO pay generates huge hidden costs. It hurts companies when CEOs focus sharply on goals that can earn them a bonus and ignore everything else or embark on risky business strategies because CEO stock options give them a big upside but no downside.

Ric Marshall, "Out of Whack: U.S. CEO Pay and Long-term Investment Returns, MSCI ESG Research Inc., October 2017, https://www.msci.com/ceo-pay.

- In 2014, the non-profit organization As You Sow developed algorithms to identify overpaid CEOs in the S&P 500. Over the next two years, the 100 most overpaid CEOs companies underperformed the S&P 500 by 2.9 percentage points. The firms with the 10 most overpaid CEOs underperformed the S&P 500 index by 10.5 percentage points.

"The 100 Most Overpaid CEOs 2018: Are Fund Managers Asleep at the Wheel?," As You Sow, March 1, 2018, http://www.asyousow.org/ays_report/the-100-most-overpaid-ceos-are-fund-managers-asleep-at-the-wheel/.

- Harvard Professors Lucian Bebchuk and Jesse Fried in their book *Pay without Performance* and subsequent papers have shown that CEO pay is negatively correlated with profitability and market valuation relative to book value. Firms with high CEO pay are not the best performers.

Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2006).

- A 2009 study by researchers at Purdue University and the University of Utah found that the companies with the highest-paid CEOs (the top 10%, adjusted for size and type of company) fall more than 4% behind expected average stock-market returns every year.

Sarah Morgan, "10 Things CEOs Won't Tell You," MarketWatch, July 1, 2011, http://www.marketwatch.com/story/10-things-ceos-wont-tell-you-1309551879312.

- A meta-analysis (a study of 137 prior studies) calculated that performance explained less than 5% of CEO pay.

Henry L. Tosi, Steve Werner, Jeffrey P. Katz, and Luis R. Gomez-Mejia, "How Much Does Performance Matter? A Meta-Analysis of CEO Pay Studies," *Journal of Management* 26, no. 2 (April 2000), doi: 10.1177/014920630002600207.

The effects on employee morale are much more expensive.[28] When the CEO makes more before lunch than you do in a year, it is hard to be inspired by his rallying cry, "There is no I in team."

However, the short-term thinking that the pay system fuels is its most costly effect. Consider stock buybacks.

The average CEO serves only 4.7 years, receives 85% of total compensation in equity awards, and typically cashes out soon after vesting. Moreover, since stock price is often a metric that drives bonus levels, CEOs have a compelling incentive to push up the stock price.

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[28] Academic studies have found that a high CEO-to-worker-pay ratio:

- Hurts employee morale and productivity.

Jeffrey Pfeffer, "Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained," *Journal of Economic Perspectives* 21, no. 4 (2007), http://www.aeaweb.org/articles.php?doi=10.1257/jep.21.4.115.

- Can cause high employee turnover and lower job satisfaction.

Matt Bloom and John G. Michel, "The Relationships among Organizational Context, Pay Dispersion, and Managerial Turnover," *The Academy of Management Journal* 45, no. 1 (2002), http://www.jstor.org/stable/3069283.

- Tends to produce high turnover and low employee morale because the high CEO pay makes other employees feel undervalued.

James B. Wade, Charles A. O'Reilly III, and Timothy G. Pollock, "Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation," *Organization Science* 17, no. 5 (2006), http://pubsonline.informs.org/doi/abs/10.1287/orsc.1060.0204.

- Can result in a lower product quality.

Douglas M. Cowherd and David I. Levine, "Product Quality and Pay Equity between Lower-Level Employees and Top Management: An Investigation of Distributive Justice Theory," *Administrative Science Quarterly* 37, no. 2 (1992), http://www.questia.com/library/1G1-12729185/product-quality-and-pay-equity-between-lower-level.

There are two paths toward this. The hard path is to beat the competition by developing new products, training and fairly paying the workforce, employing new technology, increasing productivity, providing excellent customer service, and controlling costs, etc. The easy path is to buy back your own stock.

In 2018 S&P 500 buybacks topped $800 billion, 75% of earnings.[29] Since 2016, dividend plus buyback have consumed all S&P earnings leaving nothing for reinvestment.[30]

According to accepted finance theory, buybacks make sense only when a company has excess cash, poor investment opportunities, and a stock below its "intrinsic" value. But flush with cash from tax cuts, corporations announced record buybacks in 2018 and 2019 as stocks soared to all time highs.

Buybacks provide only a one-time EPS (earnings per share) boost by reducing the number of shares outstanding. Sound investments can generate decades of gains. Between 2008 and 2015, McDonald's allocated about $18 billion to stock buybacks. The reduction in shares outstanding generated a 4.4% increase in EPS. However, had McDonald's invested this amount at a measly 2.3% annual return, its EPS would have increased more.[31] The theory that business executives will allocate capital efficiently breaks down when it is in their self-interest not to do so.

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[29] SHAWN TULLY, "Why Curbing Stock Buybacks Could Backfire," *Fortune*, February 26, 2019.

[30] https://www.yardeni.com/pub/buybackdiv.pdf

[31] Gretchen Morgenson, "In Yahoo, Another Example of the Buyback Mirage," *New York Times*, March 25, 2016, http://www.nytimes.com/2016/03/27/business/in-yahoo-another-example-of-the-buyback-mirage.html.

But the greatest damage from CEO pay falls not upon the companies themselves, but the entire economy.

Income inequality in America has risen sharply since 1980. Economists point to multiple causes including globalization and competition from low wage countries, technological changes that reward the highly skilled, the decline of labor unions, tax cuts and other conservative economic and tax policies, free market worship and the rise of winner-take-all economics, and corporate cultures that place stock price and earnings above employees.[32]

All of the above may contribute to inequality. However, the proximate cause is quite simple. The jump in inequality is due to a small number of people, mostly business executives, who make huge amounts of money. They are the top 0.1% who averaged $6.4 million in income in 2012.[33] The 0.1%, 160,000 households, hold 22% of the nation's wealth, as much as the bottom 90%.[34] The 0.1% share has doubled since 1995.[35]

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[32] *See* Robert Kuttner, *Can Democracy Survive Global Capitalism?* (New York: W. W. Norton & Company, 2018) and Joseph E. Stiglitz, *Globalization and Its Discontents Revisited: Anti-Globalization in the Era of Trump* (New York: W. W. Norton & Company, 2017).

[33] Ryan Gorman, "Wealth of Super Rich 0.1 per cent Is Pulling Even Further Ahead of the Rest of the Country," *Daily Mail*, April 1, 2014, http://www.dailymail.co.uk/news/article-2593874/Super-rich-pulling-ahead-majority-one-centers.html.

[34] Emmanuel Saez and Gabriel Zucman, "Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data" Table 1 (NBER Working Paper No. 20625, October 2014), http://www.nber.org/papers/w20625.

[35] Nelson D. Schwartz, "In an Age of Privilege, Not Everyone Is in the Same Boat," *New York Times*, April 23, 2016, http://www.nytimes.com/2016/04/24/business/economy/velvet-rope-economy.html.

You might be surprised to learn that the majority of the 0.1% are not athletes, movie stars, and heiresses. CEOs and other business executives constitute over three-fifths of the top 0.1%.[36] As Nobel Prize-winning economist Paul Krugman puts it, "Basically, the top 0.1% is the corporate suits, with a few token sports and film stars thrown in."[37]

Whether increasing inequality helps or hurts the economy is the wrong question. The right question (and an easier one) is, "Given where America is today, will greater or lesser income inequality spur economic growth?"

From 1950 to 1979, while the CEO pay ratio was relatively constant, per capita GDP increased at 2.6% annually. When the CEO pay ratio surged from 1980 through the first half of 2017, this number dropped to 2.1% a year.[38] The difference may sound small, but over the average American's lifetime, the higher growth rate results in per capita GDP that is 45% larger.[39]

Even the poorest of countries can produce growth spurts for a few years, but sustained growth, such as the United States and western European countries enjoyed from

[36] Jon Bakija, Adam Cole, and Bradley T. Heim, "Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data," April 2012, http://web.williams.edu/Economics/wp/BakijaColeHeimJobsIncomeGrowthTopEarners.pdf.

[37] Paul Krugman, "But The Top 0.1 Percent Isn't Diverse," The Opinion Pages, *New York Times*, January 15, 2012, https://krugman.blogs.nytimes.com/2012/01/15/but-the-top-0-1-percent-isnt-diverse/.

[38] https://fred.stlouisfed.org/series/A939RX0Q048SBEA.

[39] Real Per Capita GDP was $50,055 in 2014, $28,133 in 1980, $28,618 in 1979, and $13,411 in 1949. http://www.multpl.com/us-real-gdp-per-capita/table/by-year.

the end of World War II through the mid-70s, is rare because it's much easier to ignite growth than to sustain it.

The International Monetary Fund (IMF) demonstrated that relatively equal income distribution was required for sustained economic growth.[40] "A 10% decrease in inequality increases the expected length of a growth spell by 50%. The effect is large, but is the sort of improvement that a number of countries have experienced during growth spells."[41] Relative income equality showed a stronger effect on sustained growth than foreign investment, trade openness, exchange rate competitiveness, or the strength of political institutions.

Income inequality suppresses economic growth by restricting opportunity for a nation's biggest economic asset — an educated, motivated, and competent workforce. According to a study by the Organization for Economic Co-operation and Development (OECD), income inequality curtails growth "by hindering human capital accumulation. It undermines education opportunities for disadvantaged individuals, lowering social mobility and hampering skills development."[42] The OECD found that the 21 developed countries would have increased their GDP by 8.5% over the past 25 years if they had not experienced increased income inequality.[43] If an 8.5% loss in GDP does not sound

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[40] Andrew G. Berg and Jonathan D. Ostry, "Equality and Efficiency," *Finance & Development* 48, no. 3 (2011), http://www.imf.org/external/pubs/ft/fandd/2011/09/berg.htm.

[41] Ibid.

[42] OECD Directorate for Employment, Labour and Social Affairs, "Focus on Inequality and Growth," December 2014, http://www.oecd.org/els/soc/Focus-Inequality-and-Growth-2014.pdf.

[43] The Gini index is a widely accepted measure of income inequality. At a Gini index of 0, everyone has the same income. At a Gini index of 1, one person garners all the income.

severe, recall that the United States' GDP loss during the Great Recession of 2008–2009 was 4%.[44]

A Gini point equals .01 or 1/100th on the scale between 0 and 1. The OECD study found that "income inequality has a negative and statistically significant impact on medium-term growth. Rising inequality by 3 Gini points, that is the average increase recorded in the OECD over the past two decades, would drag down economic growth by 0.35 percentage point per year for 25 years: a cumulated loss in GDP at the end of the period of 8.5%."

[44] GDP totaled $14.96 trillion at the end of the second quarter of 2008 and fell to $14.36 trillion one year later.

Rising income inequality also hurts growth by increasing crime and incarceration,[45] imposing higher costs on health care and education,[46] leading to political decisions such as biased tax and regulatory policies,[47] and making the economy more vulnerable to economic shocks.

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[45] In theory, increased inequality will lead to more crime, especially property crime. If your alternative is dismal poverty, stealing becomes more attractive and prison is less of a deterrent. This theory is supported by empirical evidence. Reviewing 17 relevant studies, Richard H. McAdams, Meltzer Professor of Law at the University of Chicago Law School concluded, "Many studies found a positive relationship between inequality and crime, many found no significant relationship, and virtually no study found a negative relationship." But the great increase in American income inequality occurred as crime rates were decreasing. Were both the theory and the studies wrong? No, because inequality is not the only factor that influences crime. In "What Accounts for the Decline in Crime," researchers determined that the decline in crime was due to three factors: the increased probability of apprehension, a stronger economy, and the aging of the population (a relative decline in 20- to 28-year-old males). They estimated that the crime rate would have dropped dramatically had not inequality increased. "Holding inequality constant at its 1980 level, we could have observed a 55% drop in property crime as opposed to a 17% drop."

Richard H. McAdams, "Economic Costs of Inequality," 2010 University of Chicago Legal Forum 23 (2010), https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=2649&context=journal_articles.

Ayse Imrohoroglu, Antonio Merlo, and Peter Rupert, "What Accounts for the Decline in Crime?" *International Economic Review* 45, no. 3 [2004], https://www.jstor.org/stable/i282692.

[46] *See The Price of Inequality: How Today's Divided Society Endangers Our Future* by Joseph E. Stiglitz; *Divided: The Perils of Our Growing Inequality* by David Cay Johnston; and *The Divide: American Injustice in the Age of the Wealth* by Matt Taibbi.

[47] *See* Torsten Persson and Guido Tabellini, "Is Inequality Harmful for Growth? Theory and Evidence" (NBER Working Paper No. 3599, January 1991), http://www.nber.org/papers/w3599.

Finally it erodes trust. Americans recognize the importance of law to a flourishing economy, but trust is even more important. Trust is the lubricant of the capitalist engine.[48]

Shareholder "say-on-pay votes" have ignored the structural CEO pay problem and addressed only the most outrageous CEO pay packages. The failure rate so far in 2019 is 1.2%.[49]

America's method of paying CEOs is both corrupt and corrupting. It is rigged by corporate insiders and has nothing to do with free markets. It neither effectively motivates nor rewards CEO performance. It harms companies, employees and the American economy. When CEOs and corporate directors neglect their fiduciary duties to the detriment of almost everyone else, it is time for government to exercise regulatory oversight.

I support all legislation that would help constrain excessive CEO pay and buybacks, so therefore I am in favor of legislation to require disclosure of information on pay raises made to executives and non-executive employees as well as on human capital management, and to study mandatory disclosure on stock repurchases.

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[48] Joseph E. Stiglitz, *The Great Divide: Unequal Societies and What We Can Do About Them* (New York: W. W. Norton & Company, 2015).

[49] https://www.semlerbrossy.com/say-on-pay/

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Statement to the House Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

Hearing:

Promoting Economic Growth:
A Review of Proposals to Strengthen the Rights and Protections for Workers

May 15, 2019
10:00 a.m.
Rayburn House Office Building, Room 2128

Economic Growth and Efficient Capital Markets:
An Agenda at Odds with Subcommittee's Bills Under Consideration

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Biographical Statement: About Mr. Copland

James R. Copland is a senior fellow at the Manhattan Institute, where he has served as director of legal policy since 2003.[1] He has authored many policy briefs; book chapters; articles in journals including the *Harvard Business Law Review* and *Yale Journal on Regulation*; and opinion pieces in periodicals including the *Wall Street Journal*, *National Law Journal*, and *USA Today*. He has testified before both houses of Congress, government agencies, state and municipal legislatures, and international bodies. He is frequently cited in news articles in outlets including the *New York Times*, the *Washington Post*, *The Economist*, and *Forbes*; and has made hundreds of media appearances on networks including PBS, Fox News, MSNBC, CNBC, Fox Business, Bloomberg, C-Span, and NPR.

Mr. Copland has authored scores of reports considering various aspects of shareholder regulation and corporate governance, as well as writing on the subject in popular[2] and academic[3] journals. On multiple occasions, Mr. Copland has been named to the National Association of Corporate Directors "Directorship 100" list, which designates the individuals most influential over U.S. corporate governance.[4]

Prior to joining the Manhattan Institute, Mr. Copland served as a management consultant with McKinsey and Company in New York and as a law clerk for Ralph K. Winter on the U.S. Court of Appeals for the Second Circuit. Mr. Copland has served as a fiduciary, director, or trustee on many corporate, nonprofit, and government boards. He holds a J.D. and an M.B.A. from Yale University, where he was an Olin Fellow in Law and Economics and a Teaching Fellow in Macroeconomics and Game Theory; an M.Sc. in Politics of the World Economy from the London School of Economics and Political Science; and a B.A. in Economics, with highest distinction and highest honors, from the University of North Carolina at Chapel Hill, where he was a Morehead Scholar and was awarded the Honors Prize in Economics.

The Manhattan Institute for Policy Research does not take institutional positions on legislation, rules, or regulations. Although my comments draw upon my long-running research on shareholder regulation and corporate governance as an Institute scholar, my statement before the subcommittee is solely my own, not my employer's.

Written Statement

Chairman Waters, Ranking Member McHenry, and members of the Committee, I would like to thank you for the invitation to testify today. My name is James R. Copland. Since 2003, I have been a senior fellow with and director of legal policy for the Manhattan Institute for Policy Research, a public-policy think tank in New York City. Although my comments draw upon my research conducted for the Manhattan Institute,[5] my statement before the Committee is solely my own, not my employer's.

The proposed legislation under consideration by the committee intersects significantly with my areas of research. Three of the proposed bills, two sponsored by Representative Axne and one sponsored by Representative Phillips, seek to increase reporting requirements for businesses related to job outsourcing, workforce composition, and executive-worker pay ratios. The fourth bill concerns corporate stock buybacks and would require the Securities and Exchange Commission (SEC) to study and engage in new rulemaking on the issue.

In short, I believe that each of the draft bills is seriously misguided and likely to retard, not promote economic growth. I strongly urge the committee not to take up these ill-considered pieces of legislation and return its focus to efforts like the bipartisan Jobs and Investor Confidence Act, which passed the House by an overwhelming margin in the last Congress.

Overview of U.S. Capital Markets

The overall state of the American economy remains strong. Unemployment rates are as low as they have been in five decades, although the share of the adult population in the workforce remains stubbornly lower than historical norms. Interest rates and inflation remain low.

Similarly, U.S. capital markets remain robust. The publicly traded stock markets are at near-record highs, having recovered from the collapse of the "dot com" stock market bubble, the September 11 attacks, and the collapse of the real-estate finance bubble and subsequent financial crisis over the first two decades of the century. Moreover, the initial-public-offering market in the United States is finally taking off after nearly two decades of weakness.

These phenomena are interrelated. As the economist Joseph Schumpeter noted in his 1942 classic *Capitalism, Socialism and Democracy*, "the process of industrial mutation . . . incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in." Schumpeter described how *financial markets* were critical in permitting economies to remake themselves—by shifting resources from less-efficient to more-efficient uses.

Notwithstanding the overall health of the financial and broader economic markets, it is clearly the case that the gains from economic growth in recent decades have not been equally shared. The reasons for this are many and varied. In labor markets, reasons for unequal sharing in economic gains' returns include but are not limited to: market shifts that increase to human capital; the entry of billions of global workers into the stream of commerce; the welcome and long-overdue entry of previously excluded women and racial minorities in domestic labor

markets; and shifts in immigration patterns tilted toward lower-human-capital workers, which puts downward pressure on wages for less-educated American workers. (Outside the labor-market context, shifts in marriage patterns and household composition exacerbate realized inequality. And disparities in the provision of education entrench and perpetuate them.)

And it is important to note that the overall strength of market valuations obscures trends toward consolidation in our publicly traded capital markets. The number of publicly traded companies in the United States today is roughly half that two decades ago. Although 2019 may shape up to be a banner year in IPO markets as several highly valued companies go public, there is no reason to believe that the trend *against* public listing for non-giant companies is abating. The reasons for this shift are varied, and include the availability of large supplies of private capital. But the fact that so many enterprises would prefer to avoid public capital markets is an indictment of our current regulatory regime.

Among the changes that have doubtless exacerbated the shift away from public listings in the last two decades are onerous new reporting requirements under Sarbanes-Oxley; increasingly hyperactive shareholder activism—led by social investors, politically controlled public pensions, and labor-union investment vehicles—oriented toward social and political goals; and increasing control over publicly traded companies by government regulators and prosecutors, including previously rare deferred prosecution agreements. Moreover, U.S. publicly traded companies are subject to shareholder litigation that is severely cabined for their privately held peers and virtually unknown in foreign jurisdictions, notwithstanding Congressional reform efforts.[6]

The bills before the committee seem geared toward addressing the first problem (inequality in economic outcomes) but broadly to ignore the latter (publicly traded markets' inhospitability to smaller companies). But they are much more likely to impair economic growth. And unfortunately, their effects are more likely to fall on those already struggling to make ends meet.

The Disclosure Bills

Traditionally, corporate law in the United States has largely resided at the state level. In the Great Depression, Congress enacted an overarching federal regulatory regime, through the Securities Act of 1933 and the Securities Exchange Act of 1934,[7] but the federal role was largely oriented toward corporate disclosure. Substantive corporate-law rules and processes were still governed by the states.

The statutory text of the securities statutes expressly calls on the SEC to require *material* facts be disclosed to investors. In 1947, the SEC defined the term "material" in Rule 405 as limiting required disclosures to "the information required to those matters to which an average prudent investor ought reasonably to be informed before purchasing the security registered." In his decision for the Supreme Court in its 1976 *TSC Industries, Inc. v. Northway Inc.* decision, Justice Thurgood Marshall explained that "Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good."[8]

Unfortunately, in recent years, the SEC has been prodded by this body to require just the sorts of disclosures that worried Justice Marshall.
For example, Section 1502 of the Dodd-Frank Act directed the SEC to order public companies to

disclose their use of products derived from the "exploitation and trade of conflict minerals originating in the Democratic Republic of the Congo."[9] The U.S. Government Accountability Office has found that "nearly all the companies required to report this information did so."[10] But the rule has not had its intended effect. Instead, it prompted a *de facto* boycott of minerals from an impoverished African nation, which "increased the probability of infant deaths in villages near the policy-targeted mines by at least 143 percent."[11]

Dodd-Frank also required, in Section 953(b), that the SEC require companies to disclose their median employee's total annual compensation, the same for their chief executive officer, and the ratio of the two amounts. In promulgating the subsequent necessary rule in 2018, the SEC noted, pointedly, "We are proposing these amendments to Item 402 in order to satisfy the statutory mandate of Section 953(b). We note that neither the statute nor the related legislative history directly states the objectives or intended benefits of the provision or a specific market failure, if any, that is intended to be remedied . . ." Academic commentary described the pay-ratio rule as "a unique approach to disclosure, which we term disclosure-as-soundbite."[12] Specifically critics described the pay-ratio rule as an approach "characterized by (1) high public salience—the pay ratio is superficially intuitive and resonates with the public to an extent much greater than other disclosure, and (2) low informational integrity . . . meaning that the information is lacking in accuracy, difficult to interpret, and incomplete."[13]

The three draft disclosure bills under consideration by this subcommittee—the two sponsored by Representative Axne and the one sponsored Representative Phillips—fall squarely within this "disclosure as soundbite" paradigm.

- ***The Pay Raise Bill.*** The Phillips bill is simply a warmed-over version of the pay-ratio disclosures currently required under Section 953(b). Whereas those disclosures apply to a *static* pay ratio, the Phillips bill would apply them to "raises," or a *change* in pay. If anything, the problems with the Dodd-Frank pay-ratio rule are exaggerated in this context. Median worker earnings are likely to move in relatively modest, predictable fashion. But executive pay might vary widely from year to year, based on hiring and retention needs, the market for such talent, and—given that compensation is regularly geared to stock-market performance—stock-price moves.

  There is generally little reason to expect the ratio of CEO pay and median worker pay to be constant—or meaningful. The market for "maximum contract" salaries under the NBA collective bargaining agreement bears little relationship to the average price of concession workers. The market for headliner Hollywood actors and actresses bears little relationship to film crews. Labor markets are segmented and pay is oriented toward marginal productivity. The right comparison group for a chief executive is not the median company worker but a host of competing candidates for a senior executive's services—including not only other companies but parallel businesses that might employ top business talent, including entrepreneurial ventures, private equity shops, investment banks, and management consultancies.

  To understand the rise in executive pay, it is important to understand that its increase has been *driven by stock investors.* Equity investors are, by definition, entitled to a corporation's residual earnings.[14] But because corporate dividend payments are discretionary rather than mandatory and because equity investors are otherwise unable to protect their interests contractually, owners of common stock face significant *agency costs*, or obstacles to enforcing their interests against corporate management. One such

risk, of course, is excessive pay and benefits for corporate managers. But another is that management may choose to *avoid risks* that investors might prefer they take. And corporate managers may also choose to avoid choices that imperil their own interests—such as selling the company to a prospective acquirer—even if such choices would create value for shareholders.[15]

As a general rule, in recent years, corporate boards—prompted by shareholders, particularly institutional investors—have worried more about the latter than the former agency costs; and they have sought to mitigate such costs by directly aligning managers' incentives with equity owners'. Stock options and other equity-compensation plans that transfer some portion of companies' ownership to chief executives and other top management, in lieu of cash compensation.[16] "Golden parachutes" and other vehicles that pay executives bonuses in the event of a change of corporate control encourage managers to be active partners rather than impediments to a company's prospective sale that offered sizable rewards to shareholders.[17]

It is unlikely that corporate boards or institutional investors will abandon plans for executive compensation that have been implemented over the last three decades—while the broader stock market has grown tenfold. But due to pay issues' "high public salience," the disclosures pushed by the Phillips bill would likely generate significant media attention adverse to the average equity owner's interests. And because the negative news stories generated by such reporting would not be required of private companies or foreign competitors, the pressure for going-private transactions and foreign acquisitions would grow.

- ***The Outsourcing Bill.*** Representative Axne's bill requiring a listing of all foreign and domestic employees, pushed by the AFL-CIO, is by and large a "disclosure as soundbite" bill akin to the pay-ratio rule and proposed legislation. Companies already regularly disclose foreign-and-domestic aggregate financials. There is no reason whatsoever why a precise tally of worker by domicile is material. Moreover, such reporting would doubtless generate confusion in reporting. Companies using wholly owned subsidiaries would appear to have more foreign presence than those contracting with foreign firms.

- ***The "Human Capital Management" Bill.*** Representative Axne's other bill, involving so-called "human capital management," also fits the "disclosure as soundbite" paradigm. Proposed by a coalition led by the United Auto Workers and other labor unions and politically controlled public-employee pension funds, the bill would require the SEC to implement a host of detailed disclosures around workforce composition and management, including "diversity" data and goals. There is little reason to believe that such disclosures are material to a profit-maximizing investor. Shareholders have routinely considered and rejected similar shareholder proposals over the last decade.[18] And such data, like those involving pay ratios, would be difficult to compare across companies and sectors. This proposed disclosure—largely designed to empower outside activists to pursue social ends through press reporting, adverse to the average diversified investor's fiduciary interests.

The Share Buyback Bill

The return of capital to shareholders—more than 70% of which are institutional investors that reallocate capital—is the most efficient way to shift societal resources to highest-value use. Five of the six largest companies in the world today, by market capitalization, are American companies that simply did not exist 50 years ago.

Any laws or rules that would limit shareholder corporations from returning capital to investors—instead favoring retaining earnings—is simply foolhardy. How exactly should the director of a textile manufacturing company in the United States reinvest company earnings? The Belgian company Picanol and the Japanese company Tsudakoma have made significant advances in air-jet loom technologies. But their products can be purchased by manufacturers worldwide. It is hard to see how reinvesting earnings internally for a U.S. textile company twenty years ago—as opposed to distributing them to shareholders able to invest funds in Google or Amazon—would not have been value destroying.

Of course, corporations that wish to distribute earnings to shareholders need not do so through share repurchases. They also may do so through paying corporate dividends. But even when the tax rates on such payouts is identical, there may be reasons why a company's board of directors, acting as fiduciaries, may prefer share repurchases to common dividends:

- ***Smoothing dividend flows.*** Dividend payments are discretionary; shareholders have no right to any distribution of capital. Nevertheless, once a given dividend level is established, many shareholders may come to expect the same level to be paid going forward. Certain classes of shareholders—retirees, pensions, and endowments that use corporate dividend flows as an income stream, rather than reinvesting them—may tend to count on a dividend level and improperly calculate expected future cash flows when corporations vary their dividend payments. Moreover, an increased dividend payment may create an improper signal to market actors if corporate fiduciaries do not expect a one-time increase in realized profits to continue into future periods. Such is a particular risk if current cash flows are abnormally high due to a one-time asset sale or tax law change.

- ***Taking advantage of share mispricing.*** Corporate boards and executives have inside information about a company's future earnings. For precisely this reason, federal courts have applied common-law prohibitions on insider trading to be actionable fraud under the federal securities laws.[19] Congress subsequently enacted statutes reifying this prohibition;[20] and the SEC promulgated clarifying regulations.[21] Whereas corporate fiduciaries are prohibited from *misappropriating* their insider knowledge for their own benefit,[22] purchasing underpriced shares *creates* value for shareholders whom fiduciaries owe a duty. Such share repurchases also have the salutary effect of improving market pricing—thus increasing capital-markets efficiency and in the aggregate, over time, reducing market volatility and episodic economic contractions driven by debt predicated on mispriced securities.

- ***Facilitating shareholder tax timing.*** Even when capital gains and dividends are treated identically in the tax code, they are not identical to individual owners of shares in a C corporation. Capital gains are only taxed when realized. Corporate dividends are taxed

> when distributed. Thus, distributing corporate earnings via dividends generates a taxable event for *all* corporate shareholders on a *pro rata* basis. But distributing corporate earnings via share repurchases creates a taxable event *only for those shareholders who sell their shares*. Thus, shareholders who view a company's market price as undervaluing its long-term value—a view implicitly consistent with the view of the board authorizing a stock buyback—can defer taxation and hold their shares. With shares repurchased by the corporation rather than outside buyers on the open market, the number of shares floated falls—and the shareholder's percentage of future earnings rises.

There is little reason for concern with publicly traded C corporations' increasing use of share buybacks. The most valuable companies in the market today are mostly new; many of yesteryear's valuable companies are significantly smaller concerns, if they still exist. Reallocating capital toward its most efficient uses is precisely the function of our capital markets. Any notion that companies should retain earnings and invest them internally rather than redistributing them to shareholders to reinvest is disastrous folly. And such reallocation should indeed be expected to increase after a significant tax code change.

The notion that a company could consistently manipulate stock prices through share buyback programs assumes a very weak notion of capital-market efficiency inconsistent with reality.

I do not mean to suggest that an announced share buyback program should have no impact on share price. An announced share buyback should be expected to have a positive short-run correlation with a company's share price, other things being equal. Such an announcement is, implicitly, a statement by a company's board that it believes the company undervalued in the public markets. And given this reality, it is conceivable that corporate insiders might "time" their sales of shares or exercise of options to take advantage of a modest price movement—as SEC Commissioner Robert Jackson finds in a preliminary analysis. The SEC may wish to study this issue further and consider the pluses and minuses of limitations on insiders' sale of shares surrounding buyback announcements.

But beyond this modest consideration, there is no reason to believe that a company could prop up its share price for long with share repurchases. Hundreds of billions of dollars trade daily on stock exchanges; and this amount significantly *understates* financial markets' modern liquidity, given hundreds of trillions of dollars in derivative contracts at any given time.

There is certainly no reason to saddle the SEC with a new study, and new rulemaking, as proposed in the new bill—particularly one larded with "soundbite" disclosures such as median employee and executive compensation, and the percentage increases in same; and considerations such as "reducing wealth inequality." On the whole, share buybacks are *good* for investors—and help to protect investors' interests, to promote efficient capital markets, and to facilitate capital formation.

Conclusion

Unlike the Jobs and Investor Confidence Act, which passed the House in the last session by a broad bipartisan majority, the bills under consideration today are certain to be divisive—and were they enacted, they would be unhelpful. I believe that each of the draft bills is seriously misguided and likely to retard, not promote economic growth. We should not allow reasonable policy concerns about income inequality to intrude on our capital-market regulation, which has long been properly oriented around the SEC's tripartite mission to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation.

The principal function of federal securities law, as opposed to state corporate law, is to promote efficient disclosure. Courts and federal regulators, understanding that disclosures have costs as well as benefits, have long oriented disclosure around a *materiality* requirement. The three proposed disclosure bills fail this standard and instead promote a "disclosure as soundbite" regime designed to generate media attention rather than inform investors pricing securities.

The principal function of capital markets is to reallocate capital to its most efficient uses. Implicit in this function is returning earnings to shareholders when internal projects, using retained earnings, are less valuable than alternative uses in the marketplace. Corporate share repurchases are an efficient mechanism for returning such capital. Share buybacks allow investors to rely on more predictable dividend flows and to time the tax treatment of their capital assets, and they facilitate efficient market pricing to shareholders' benefit through corporate fiduciaries' use of corporate information. Although it is within the SEC's regulatory scope to oversee corporate repurchases, and the Commission should continue to investigate potential short-term convergence between share repurchases and insider stock sales, the overall scope of such concerns is overblown—and the proposed cure here far more dangerous than the concerns.

Although I believe that capital markets are functioning well and the economy is exhibiting solid growth, there are reasons for concern. Chiefly, the number of publicly traded companies remains lower than it was two decades ago; initial public offerings may be on the uptick in dollar volume but have languished for far too long. Investors and corporate fiduciaries have sent strong signals that our capital markets, today, make sense only for the very largest enterprises. Among the government burdens on publicly traded companies in the market that should concern policymakers are:

- Onerous reporting requirements, under Sarbanes-Oxley and other new dictates
- Socially oriented shareholder activism and reduced director discretion
- Inordinate influence by proxy advisory firms
- Corporate criminal investigations, applying sanctions unavailable at trial
- Shareholder litigation

I have written about many of these issues. A selected list of writings I have authored or published follows, and should be incorporated by reference. I encourage members of the committee to ask questions, which I will endeavor to answer to the best of my ability.

Further Resources

Testimony

James R. Copland, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Apr. 2, 2019, *available at* https://www.banking.senate.gov/imo/media/doc/Copland%20Testimony%204-2-191.pdf.

James R. Copland, Testimony before the House Financial Services Subcommittee on SEC Rule 14a-8, Sept. 21, 2016, *available at* https://media4.manhattan-institute.org/sites/default/files/T-JC-0916.pdf.

James R. Copland, Testimony before the House Financial Services Committee, Apr. 26, 2006, *available at* https://www.manhattan-institute.org/html/testimony-james-r-copland-united-states-house-representatives-committee-financial-services-6053.

Reports

James R. Copland et al., *Proxy Advisory Firms: Empirical Evidence and the Case for Reform* (Manhattan Institute 2018), *available at* https://media4.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.

James R. Copland & Margaret M. O'Keefe, *Proxy Monitor 2016: A Report on Corporate Governance and Shareholder Activism* (Manhattan Institute 2016), *available at* http://www.proxymonitor.org/pdf/pmr_13.pdf.

James R. Copland & Steven Malanga, *Safeguarding Public Pension Systems—A Governance-Based Approach* (Manhattan Institute 2016), *available at* https://media4.manhattan-institute.org/sites/default/files/R-JCSM-0316.pdf.

Tracie Woidtke, *Public Pension Fund Activism and Firm Value* (Manhattan Institute 2015), *available at* https://media4.manhattan-institute.org/sites/default/files/lpr_20.pdf.

Article

James R. Copland, "Against an SEC-Mandated Rule on Political Spending Disclosure: A Reply to Bebchuk and Jackson," 3 *Harvard Business Law Review* 381 (2013), *available at* http://www.hblr.org/wp-content/uploads/2013/10/HLB209_crop.pdf.

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James R. Copland, "Senator Warren's Bizarro Corporate Governance," ECONOMICS21.ORG, Aug. 16, 2018, *available at* https://economics21.org/warren-backwards-corporate-governance.

James R. Copland, "Another Shareholder Proposal? McDonald's Deserves a Break Today," *Wall Street Journal*, Jul. 7, 2017, *available at* https://www.wsj.com/articles/another-shareholder-proposal-mcdonalds-deserves-a-break-today-1499381801.

Howard Husock & James R. Copland, "'Sustainability Standards' Open A Pandora's Box Of Politically Correct Accounting, *Investor's Business Daily*, Mar. 24, 2017, *available at* https://www.investors.com/politics/commentary/sustainability-standards-open-a-pandoras-box-of-politically-correct-accounting/.

James R. Copland, "Getting The Politics out of Proxy Season," *Wall Street Journal*, Apr. 23, 2015, *available at* https://www.manhattan-institute.org/html/getting-politics-out-proxy-season-5461.html.

James R. Copland, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal*, Oct. 7, 2012, *available at* https://www.manhattan- institute.org/html/politicized-proxy-advisers-vs-individual-investors-3863.html.

James R. Copland, "Are U.S. IPOs DOA?," *WashingtonPost.com*, Apr. 12, 2007, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/04/11/AR2007041101723.html.

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[1] *See* James R. Copland, https://www.manhattan-institute.org/expert/james-r-copland. The Manhattan Institute is a non-profit, non-partisan think tank developing ideas that foster economic choice and individual responsibility. *See* About MI, https://www.manhattan-institute.org/about.

[2] *See, e.g.*, James R. Copland, *Another Shareholder Proposal? McDonald's Deserves a Break Today*, WALL ST. J., Jul. 7, 2017, *available at* https://www.wsj.com/articles/another-shareholder-proposal-mcdonalds-deserves-a-break-today-1499381801; *Getting The Politics out of Proxy Season*, WALL ST. J., Apr. 23, 2015, *available at* https://www.manhattan-institute.org/html/getting-politics-out-proxy-season-5461.html; *Politicized Proxy Advisers vs. Individual Investors*, WALL ST. J., Oct. 7, 2012, *available at* https://www.manhattan- institute.org/html/politicized-proxy-advisers-vs-individual-investors-3863.html.

[3] *See* James R. Copland, *Against an SEC-Mandated Rule on Political Spending Disclosure: A Reply to Bebchuk and Jackson*, 3 HARV. BUS. L. REV. 381 (2013).

[4] *See, e.g.*, NACD 2012 Honorees, https://www.nacdonline.org/directorship100/2012honorees.cfm ("Each year, NACD Directorship identifies the most influential people in the boardroom community, including directors, corporate governance experts, journalists, regulators, academics and counselors.").

[5] Some language in this testimony may be substantially similar to, or in some places identical, to that in my previous publications and earlier testimony before other government bodies.

[6] *See, e.g.*, Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737.

[7] *See* Securities Act of 1933, Pub. L. No. 73-22, Ch. 38, 48 Stat. 74 (1933) (codified at 15 U.S.C. §§ 77a–77aa (2006 & Supp. II 2009)); Securities Exchange Act of 1934, Pub. L. No. 73-291, Ch. 404, 48 Stat. 881 (1934) (codified at 15 U.S.C. §§ 78a–78oo (2006 & Supp. II 2009)).

[8] 426 U.S. 438, 448 (1976).

[9] The Dodd-Frank Wall Street Reform and Consumer Protection Act, § 1502(a), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[10] Company Reports on Mineral Sources in 2017 Are Similar to Prior Years and New Data on Sexual Violence Are Available, GAO-18-457, Jun 28, 2018.

[11] Dominic P. Parker, Jeremy D. Foltz & David Elsea, *Unintended Consequences of Sanctions for Human Rights: Conflict Minerals and Infant Mortality*, 59 J. LAW & ECON. 731, 731-774 (Nov. 2016).

[12] Steven A Bank & George S. Georgiev, *Securities Disclosure As Soundbite: The Case of CEO Pay Ratios*, B.C. LAW REV., (January 29, 2019), *available at* https://ssrn.com/abstract=3324882 or http://dx.doi.org/10.2139/ssrn.3324882.

[13] *Id.*

[14] In accounting, corporate finance, and bankruptcy law, equity owners have the lowest priority claim to a corporation's assets; *i.e.*, owners of equity capital are only paid after all other creditors and claimants in a corporate liquidation. *Cf.* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288-89 (1980) (arguing against "the typical presumption that a corporation has owners in any meaningful sense" and instead defining equity owners by their entitlement only to a residual claim on the corporation).

[15] *See generally* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (The MacMillan Company, 1932) (a classical exploration of agency costs in the American corporation which remains a principle focus of corporate-law literature).

[16] *See, e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1530 (2007) ("The 1990s board undertook . . . . to fashion executive compensation contracts that better aligned managerial and shareholder objectives, to give managers high-powered incentives to maximize shareholder value. In light of other institutional constraints, this meant stock options." (footnote omitted)).

[17] *See id.* at 1533-34 ("[Another] element of the 1990s board's focus on shareholder value in the market for managerial services was the 'golden parachute,' a generous severance package that was another alignment mechanism. . . . In the

case of an uninvited premium takeover bid, such packages often converted CEOs from opposition to acquiescence.").
[18] *See generally* www.ProxyMonitor.org.
[19] *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Dirks v. SEC, 463 US 646 (1983).
[20] *See, e.g.*, The Insider Trading Sanctions Act of 1984, Pub. L. 98-376, 98 Stat. 1264 (1984).
[21] *See* SEC Rule 10b5-1, *codified at* 17 C.F.R. 240.10b5-1 (2000).
[22] *See* United States v. O'Hagan,521 U.S. 642 (1997) (articulating misappropriation theory).

Testimony of Heather Slavkin Corzo
Director of Capital Markets Policy, AFL-CIO
Senior Fellow, Americans for Financial Reform

Before Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
U.S. House of Representatives
On
Promoting Economic Growth: A Review of Proposals to Strengthen the Rights and Protections for Workers

May 15, 2019

Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee, thank you for inviting me to testify. My name is Heather Slavkin Corzo. I am the Director of Capital Markets Policy for the AFL-CIO and a Senior Fellow at Americans for Financial Reform. The AFL-CIO is America's labor federation representing 55 national and international labor unions and more than 12 million working people. AFR is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry.

The AFL-CIO and AFR work on behalf of millions of people to promote policies that create a safe, sound and stable economy that helps all Americans achieve economic security.

Working people, consumer and retirees need a healthy and fair financial system to provide financing for business and allow access to safe, affordable credit to buy homes or make other major purchases. Those of us fortunate to have retirement savings need a safe place to invest.

The AFL-CIO has, since its founding, seen ensuring the retirement security of working people as a central mission of the labor movement—both through our advocacy for Social Security and Medicare and through collective bargaining with employers. Today, collectively bargained retirement plans in this country account for more than $7 trillion of invested capital. While the ownership of stocks and bonds remains predominantly in the hands of the wealthiest Americans, working people are major investors through our benefit funds, and our retirement security is bound up with the health of the financial system. For these reasons the labor movement has been actively engaged for decades in promoting effective, common sense regulation of our capital markets.

1. Promoting Economic Growth: A Review of Proposals to Strengthen the Rights and Protections for Workers

Today, the Subcommittee will consider a number of legislative proposals aimed at modernizing corporate disclosures to enable investors to more effectively integrate human capital management information into investment processes. In addition, the Subcommittee will consider a proposal that directs the SEC to address stock buybacks, a leading example of how companies use financial engineering to drive up stock prices at the expense of employee compensation and productive investment in growing their businesses.

I commend the Subcommittee for taking up these critical issues.

Investors in the US and internationally are increasingly taking a more holistic view of the risk and reward profiles of their investment portfolios. There is an increasing acknowledgment that environmental, social and governance ("ESG") matters are material financial factors that responsible investors must incorporate into investment decisions. Investors with $86 trillion globally, including US investors with $42 trillion under management, have signed up to the Principles for Responsible Investment, committing to incorporate ESG factors into investment decisions, engage with companies to encourage more responsible ESG practices, and seek ESG disclosure from companies in their portfolios.[1]

For investors, many of whom are large and widely diversified, the focus on ESG factors is about mitigating risks that can negatively impact investment performance over time. Pension funds, for example, are responsible for providing retirement security to current retirees as well as workers just beginning their careers who may be 40 years or more away from retirement. Companies that fail to integrate systemic risks, like climate change and income inequality, into their business models today are at greater risk of failing to remain competitive over the long-term.

While this Subcommittee is focused on investor protection, I am encouraged that today's hearing reveals an understanding of the reality that the best way for investors to do well is to invest in a stable, sustainable and growing economy. Sound economic growth requires employers to invest in workers and workforce development, to provide family-sustaining compensation packages so that our consumer-driven economy can thrive, and to devote resources to strategies that give their enterprises the chance to prosper in the future.

The testimony that follows will discuss each of the topics addressed in the legislation put forward today. In addition, I will discuss further measures to empower private sector workers including through the mandatory appointment of workers to corporate boards of directors and additional regulation of private equity.

2. Human capital management disclosure

The Securities Act of 1933 and the Securities Exchange Act of 1934 form the statutory foundation of our capital markets regulation in large part by imposing reporting obligations on issuers. This mandatory reporting provides the basis on which investors are able to make informed investment decisions. The theoretical underpinnings of our economic system depend on investors receiving and utilizing that information when making investment decisions.

[1] 'About the PRI' *available at* https://www.unpri.org/pri.

In a disclosure-based regime such as this, quality, quantity and form of disclosure are paramount in establishing its efficacy. Broad-based disclosure can also improve transparency, combat short-termism and build public trust, confidence and understanding of capital markets.

Regulation S-K, under the securities laws, defines core reporting requirements for public companies. It structures a disclosure system where issuers have general obligations to disclose material information, and specific requirements to disclose information whose disclosure the Commission finds to be per se in the interests of investors and the public.

However, this system has not kept pace with developing investor understanding of what information is relevant to investor decisions. One example of particular importance, both from an investor and a public interest perspective, is ESG issues. In this area, unlike other areas of issuer disclosure, the decision as to what to disclose is left almost entirely up to issuers to determine. The lack of per se, line item ESG disclosure requirements has meant, in effect, that issuers have excessive discretion to determine what information is, or is not, disclosed to investors.

Human capital management ("HCM") disclosure is a component of ESG disclosure. HCM refers to a set of practices and strategies for how a company recruits, manages and develops its human capital (i.e. workforce). Executives are always quick to say that their workforce is their greatest asset yet rarely offer information on how that asset is maintained, cultivated or grown. Likewise, many companies describe the cost of labor as one of their biggest expenses yet offer little information on what that cost is comprised of or how it is managed.

Presently, companies must only disclose a single metric regarding their human capital: the number of workers, which is often accompanied by generic statements about the need to attract and retain the best employees. Furthermore, any investment in human capital is buried in the Selling, General and Administrative Expenses ("SG&A") disclosure, indistinguishable from money spent on office supplies or corporate lunches. Any investment in human capital is essentially viewed as overhead and not an investment in the firm.

HCM is a key driver of corporate performance and an essential indicator of a company's value creation strategy and long-term viability. There is both significant and growing research demonstrating this link as well as clear and growing investor demand for this information. [2]

The Human Capital Management Coalition ("HCMC") was formed in 2013 to advocate for enhanced corporate disclosure of HCM metrics. It now includes investors with more than $3 trillion in assets under management.[3] In 2017, the HCMC petitioned the US Securities and Exchange Commission to update disclosure requirements to ensure that investors have access to data, in a consistent and comparable format, to evaluate how companies are managing their

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[2] See Anthony Hesketh letter to Anne Sheehan, Chair of the Investor Advisory Committee of the SEC, Mar. 21, 2019 *available at* https://www.sec.gov/comments/265-28/26528-5180428-183533.pdf. "[F]irm financial performance increases in step with human capital reporting intensity... in the U.S., where human capital disclosure is less extensive, top-quartile reporting firms ($2.09 for every $1 invested in their talent) on average outperform the returns secured from talent by those in the bottom quartile of human capital reporting ($1.87)."

[3] More information about the Coalition is available at http://www.uawtrust.org/hcmc.

human capital.[4]

Given the connection to performance and the broad call for disclosure, policy changes are needed to update disclosure requirements to provide for robust human capital disclosures.

Disclosures including, but not limited to, investment in workforce training and education; annual employee turnover, voluntary and involuntary; gender pay disparity; outsourcing; and benefits and incentive structures available to employees, including comparisons to those available to executives would enable investors to make informed investment decisions based on the trends in a company's workforce, and to better assess the competitiveness and productivity of companies.

For these reasons, the AFL-CIO and AFR support Rep. Axne's discussion draft, which would "require issuers to disclose information about human capital management in annual reports."

a. Offshoring

Companies have long been required by the SEC to disclose their global employee headcount. Traditionally, companies would break out their US and international employees. In recent decades, this voluntary disclosure has declined. One possible explanation for the declining reporting is that multinational companies have increasingly focused job creation in non-US markets and would prefer not to disclose numbers that could lead to reputational risks.

Offshoring is an important component of HCM. It would help investors analyze companies' strategic plans, exposures to geopolitical risk and risk from extreme weather events. From a public policy perspective, such disclosure will also allow the public to see the effect of the corporate tax cut on encouraging offshoring. The discussion draft put forward by Rep. Axne "to require the disclosure of the total number of domestic and foreign employees of a company" would go a long way towards providing investors the information they need to integrate offshoring into the evaluation of companies' HCM.

b. Pay ratio

The AFL-CIO and AFR are long-time supporters of disclosure of enhanced corporate reporting of CEO-to-worker pay ratios. Executive pay has skyrocketed over the past few decades and is often completely divorced from company fundamentals. At the same time, most American workers have faced wage stagnation despite increasing productivity. This raises serious questions about corporate strategies, values and long-term outlook.

In order to be the rational decision makers that the market expects investors to be, investors need information. The pay-ratio rule brings transparency to corporations' compensation strategies. While it might seem straightforward, this information is tremendously important to investors in our current economy.

There is a substantial body of research that shows correlations between out-of-balance pay ratios and a number of poor performance indicators—in particular, the morale of the

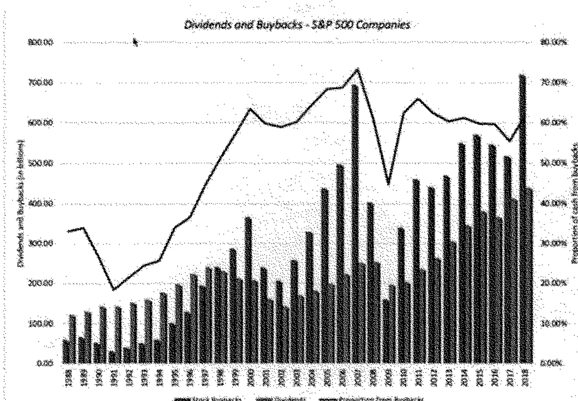
[4] "$2.6 Trillion Investor Coalition Sees Link Between Human Capital Management and Shareholder Return" Engagement Strategies Media. Available at: http://www.enterpriseengagement.org/articles/content/8472962/26-trillion-investor-coalition-sees-link-between-human-capital-management-and-shareholder-return/.

workforce, as well as its productivity and loyalty—while balanced pay ratios are indicators of strong long-term performance.

The pay ratio data that has been published since the SEC rule implementing Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act went into effect last year has been useful to investors in analyzing companies' compensation strategies. Additional data points in this area would further inform investor analysis. The AFL-CIO and AFR, therefore, support the discussion draft "to require issuers to disclose information on pay raises made to executives and non-executive employees."

3. Stock buybacks

In recent decades, companies have spent exorbitant sums buying back their own stock. The 2017 Tax Cuts and Jobs Act hyper-charged the practice. In 2018, companies spent more than $1 trillion buying back their own stock and are on pace to surpass that level in 2019.[5]

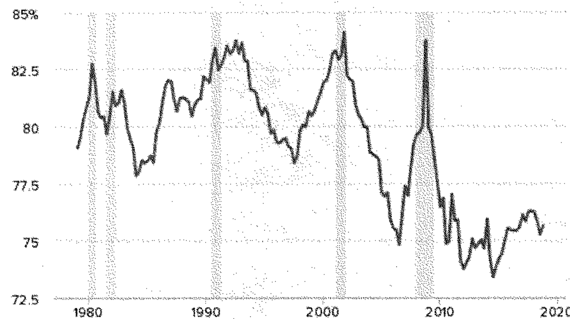


From: Seeking Alpha[6]

At the same time, the portion of corporate earnings used to pay workers is near all-time lows for the modern era.

[5] Ben Walsh, *Stock Buybacks Are on Track for Another Record Year*, Barron's, Feb. 20. 2019 *available at* https://www.barrons.com/articles/stock-buybacks-are-on-track-for-another-record-year-51550682106?mod=article_inline.

[6] Aswath Damodaran, *January 2019 Data Update 8: Dividends And Buybacks - Fact And Fiction*, Seeking Alpha, Feb. 10, 2019, *available at* https://seekingalpha.com/article/4239687-january-2019-data-update-8-dividends-buybacks-fact-fiction.



Company's excessive spending on buybacks has prompted concerns that they are prioritizing short-term stock price jumps over long-term investments that would make their businesses more competitive. According to The Economist magazine, "If firms are overdoing buy-backs and starving themselves of investment, artificially propped-up share prices will eventually tumble."[7] Large stock buybacks send "a discouraging message about a company's ability to use its resources wisely and develop a coherent plan to create value over the long term," Laurence Fink, chairman and CEO of Blackrock, wrote in an April 14, 2015 letter to S&P 500 companies.

Company executives whose compensation is primarily comprised of stock-based awards gain the most from short-term maneuvers to boost stock prices. As is so often the case with financial engineering, workers and long-term investment in business improvements suffer. For example, if Wal-Mart had chosen to invest the $10 billion allocated for stock buybacks in 2018 to raising workers' wages, it could have paid each worker an additional $5.66 per hour.[8] Between 2015 and 2017, GE bought back $40 billion in stock, at rates far above its current share price, and is now has nearly $100 billion in outstanding debt.[9] At the same time, the

[7] *Share buybacks: Corporate Cocaine,* The Economist, Sep. 13, 2014 *available at* https://www.economist.com/leaders/2014/09/13/corporate-cocaine.

[8] Lenore Palladino, *Rewriting the Rules to Take Aim at Stock Buybacks and Force Companies to Invest in Their Workers: The STOP Walmart Act*, Medium, Nov. 14, 2018 *available at* https://medium.com/@lenorepalladino/rewriting-the-rules-to-take-aim-at-stock-buybacks-and-force-companies-to-invest-in-their-workers-7463680414c5.

[9] Martin Hutchinson, *Opinion: Misguided share buybacks are hollowing out companies' balance sheets and will lead to even bigger stock-market trouble*, MarketWatch.com, Nov. 21, 2018 *available at* https://www.marketwatch.com/story/misguided-share-buybacks-are-hollowing-out-companies-balance-sheets-and-will-lead-to-even-bigger-trouble-2018-11-20.

company has cut thousands of jobs in the US.[10]

SEC policy changes in the early 1980s opened the door for the proliferation of stock buybacks. Prior to the issuance of Rule 10b-18, it was generally thought that stock repurchases would be considered stock price manipulation by the SEC. 10b-18, however, created a safeharbor that gave companies comfort that they would not be charged by the Commission with manipulation and buybacks took off.

Multiple policy changes have been put forward to limit buybacks. Senator Baldwin's Reward Work Act would eliminate the 10b-18 safeharbor and require companies to include worker representatives on the boards of directors. Senators Schumer and Sanders have announced plans to introduce a bill that would condition the ability of companies to buy back their stock on adherence to a $15 minimum wage.

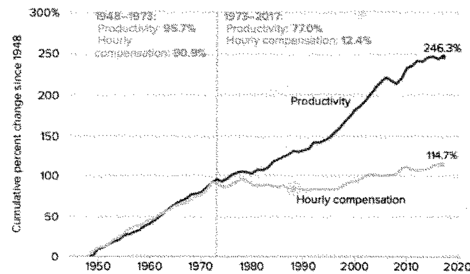
Today, the Subcommittee considers a draft bill "to study whether to amend the rules of the Commission relating to certain stock repurchases." In my view, the basic facts are already clear, and it is time for action.[11] Congress must pass legislation to affirmatively address stock buybacks before companies spend trillions of dollars more to artificially boost their stock prices – trillions of dollars that could be invested in research and development, growth, and employee compensation and training.

4. Worker representation on corporate boards of directors

From the post-World War II period until the early 1970s, workers' wages and productivity rose in tandem. In the early 1970s, however, the connection broke down. Since then, wages have stagnated despite dramatic improvements in productivity.

The gap between productivity and a typical worker's compensation has increased dramatically since 1973

Productivity growth and hourly compensation growth, 1948–2017



Notes: Data are for compensation (wages and benefits) of production/nonsupervisory workers in the private sector and net productivity of the total economy. "Net productivity" is the growth of output of goods and services less depreciation per hour worked.

Source: EPI analysis of unpublished Total Economy Productivity data from Bureau of Labor Statistics (BLS) Labor Productivity and Costs program, wage data from the BLS Current Employment Statistics, BLS Employment Cost Trends, BLS Consumer Price Index, and Bureau of Economic Analysis National Income and Product Accounts

Updated from Figure A in *Raising America's Pay: Why It's Our Central Economic Policy Challenge* (Bivens et al. 2014)

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[10] Darrell Proctor, *GE Will Cut Jobs, End Manufacturing at Virginia Plant*, PowerMag.com, Jun. 11, 2018 *available at* https://www.powermag.com/ge-will-cut-jobs-end-manufacturing-at-virginia-plant/?pagenum=1.

[11] William Lazonick, *Profits Without Prosperity*, Harvard Business Review. Sep. 2014 *available at* https://hbr.org/2014/09/profits-without-prosperity.

The single-most effective way to improve workers' rights and address income inequality is to empower workers to command better wages, benefits and working conditions. In the corporate governance context, which is the jurisdiction of this Subcommittee, this means ensuring worker representation on corporate boards.

In many advanced economies with highly-competitive private sector businesses, worker representation on boards has been in place for decades. According to research by Roosevelt Institute Senior Economist and Policy Counsel Lenore Palladino:

> In other advanced industrialized economies, balanced models of corporate governance are the norm. In two-thirds of Europe, workers have a role on the corporate board, and in 13 countries, including Germany and France, worker governance rights are extensive across much of the private sector… In these examples, shareholders still maintain a substantial and powerful presence, but workers are also able to participate in the conversation. Europe shows us that there are many ways a stakeholder model can be implemented, and ours does not need to duplicate any one existing framework.[12]

Worker representation on boards is common practice in other parts of the world and could help lead to better management decisions. In large, modern corporations, board members and senior executives are often insulated from rank-and-file workers. This contributes to a lack of communication and trust between workers and leading decisionmakers. As a result, strategic decisions by corporate leaders are often made without input from the individuals who will be responsible for implementing those policies. This disconnect can lead to sub-optimal results.

The sales quota scandal at Wells Fargo is a leading example. Workers at the company repeatedly attempted to call attention to problems in the bank's sales culture but attempts to raise the issue through internal processes failed. The problem could have been addressed earlier if workers had an effective means to make their concerns known. Worker representation on the Wells Fargo board would have enabled earlier board-level conversation about the depth of the problem at the company.

Finally, research has shown that poor labor relations lead to higher unemployment and that more interaction between workers and their employers can lead to higher levels of trust and improved relationships.[13] Worker representation on boards would create additional interaction and improved relationships.

Multiple Senate bills would require worker representation on boards. Senator Tammy Baldwin's Reward Work Act would allow workers to select one-third of the members of a company's board of directors and improve disclosure of stock buybacks. Senator Elizabeth Warren's Accountable Capitalism Act would allow workers to elect 40% of corporate board members and create other mechanisms to encourage large companies to integrate more stakeholders' interests into their decisions. The AFL-CIO and AFR support these bills and we

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[12] Lenore Palladino, *Why Workers On Corporate Boards Just Makes Sense*, RooseveltInstitute.org: Published in Blog, Economic Inclusion, Economy & Growth, Work and Labor, Aug. 14, 2018 *available at* https://rooseveltinstitute.org/why-workers-corporate-boards-just-makes-sense/

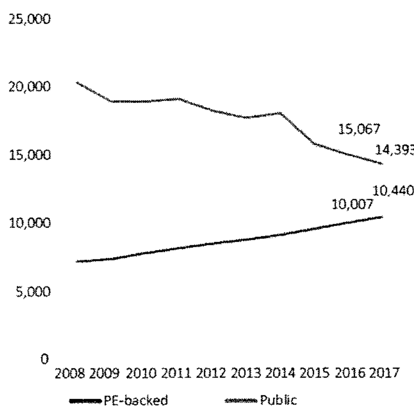
[13] Blanchard, Olivier J. and Philippon, Thomas, The Quality of Labor Relations and Unemployment (June 15, 2004). MIT Department of Economics Working Paper No. 04-25. Available at SSRN: https://ssrn.com/abstract=559203 or http://dx.doi.org/10.2139/ssrn.559203.

encourage the Subcommittee to consider the issue.

5. Private equity

Private equity investment strategies have a growing and underappreciated impact on the US economy. Assets held by private equity ("PE") firms have grown from $1 trillion prior to the financial crisis to a new record of $3.1 trillion in 2017, with another $1 trillion in committed capital waiting to be invested.[14] Today, PE-owned companies employ nearly 11.3 million American workers.[15] We have seen a steep decline in the number of publicly-traded companies over the last decade, while at the same time, the number of PE-backed companies has grown rapidly.

Convergence between public and PE-backed companies continues
North American and European companies (#) by backing status



Source: PitchBook
Note: Due to a lag in the reported data, this data is presented through full-year 2017.

Comment by Eileen Appelbaum to FTC on Proposed Consent Agreement in the Matter of Staples/Essendant, Inc.

The PE model often serves as a vehicle to allow extremely wealthy PE managers ("PE general partners" or "GPs)" to take control of real economy businesses, which provide goods and services of value to the public, and extract wealth from these businesses. This is accomplished using cash provided by outside investors, many of which are pension plans

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[14] *Press Release: Private Equity Industry Grows to More Than $3tn in Assets*, Preqin, Jul. 24, 2018 *available at* http://docs.preqin.com/press/PE-Assets-Jul-18.pdf.

[15] Financial Services Spotlight: The Financial Services Industry in the United States, SelectUSA.gov *available at* https://www.selectusa.gov/financial-services-industry-united-states.

who pay exorbitant fees to the GPs for the privilege of investing.

'Private equity' is often the modern term used to refer to leveraged buyouts, which gained notoriety in the 1980s. PE owners typically use large amounts of debt in their acquisitions, which result in lower tax bills for the companies but greater risk. Companies are often forced to cut workers' wages and benefits to keep up with debt payments and are more likely to end up in bankruptcy, at which point workers, suppliers, and other creditors all suffer losses. Now, the size of the market for risky corporate debt has reached a point at which global regulators are raising concerns that an economic downturn could lead to a wave of defaults and systemic risk.

a. Private equity and workers

Private equity observers have long been concerned that the strategy, due to its reliance on high levels of leverage and the resulting cash constraints the leverage creates for companies, can result in lower wages and benefits for workers. Increasing amounts of empirical evidence supports this belief. One independent analyst has concluded that more than 60% of the retail jobs loss in 2016 and 2017, around 130,000 jobs, were at companies owned by PE.[16]

i. Toys 'R' Us

Toy 'R' Us is a recent example of a PE-owned company that ended up in bankruptcy. The toy store was purchased by a consortium of PE firms in 2005 for $6.6 billion. Despite $11 billion in annual sales, Toys 'R' Us struggled to service the $5 billion debt put on the companies by the PE owners and filed for bankruptcy in 2018.[17] When the company entered liquidation, it left 31,000 employees out of work.[18]

Toys 'R' Us's PE owners have blamed its failure on competition from online retail providers, like Amazon, and other market forces. Multiple analysts, however, have said the blame rests to a very substantial degree with the company's unsustainable debt and warned that other retail chains could fail in a similar fashion due to high-risk private equity investments.[19]

ii. Caesars

The casino company, Caesars Entertainment Corporation (formerly Harrah's Entertainment), provides another example. It was purchased by private equity firms Apollo and TPG in a 2008 leveraged buyout that was financed using $23 billion of debt.[20] The company then conducted a series of financial engineering maneuvers, culminating in a complicated

[16] Steve LeVine, *Vulture capitalists are killing off retail jobs*, Axios, Jan. 10, 2018 *available at* https://www.axios.com/private-equity-1515603080-efd39541-a9fb-474b-8c24-04623ee518fd.html.

[17] Jessica DiNapoli and Tracy Rucinski, *How $5 billion of debt caught up with Toys 'R' Us*, Reuters, Sept. 17, 2017 *available at* https://www.reuters.com/article/us-toys-r-us-bankruptcy-timeline/how-5-billion-of-debt-caught-up-with-toys-r-us-idUSKCN1BV0FQ.

[18] Chris Isidore, *31,000 Toys 'R' Us employees: No job and no severance*, CNN, Mar. 16, 2018 *available at* https://money.cnn.com/2018/03/16/news/companies/toys-r-us-employees/index.html.

[19] Dave Dayen, The Cause and Consequences of the Retail Apocalypse, The New Republic, Nov. 14, 2017 *available at* https://newrepublic.com/article/145813/cause-consequences-retail-apocalypse.

[20] Gretchen Morgenson, *Caesars' Debt: A Game of Dealer's Choice*, NY Times, Sep. 13, 2014, *available at* https://www.nytimes.com/2014/09/14/business/caesars-debt-a-game-of-dealers-choice.html.

bankruptcy and asset sales.[21]

Under Apollo and TPG, Caesars made dramatic cuts to investment in its properties and its workforce. Before the leveraged buyout, Caesars spent $2.5 billion in 2006, $1.5 billion in 2007, and $1.8 billion in 2008, or an average of $1.7 billion per year on capital expenditures to renovate and build new properties.[22] Between 2009 and 2016, under the Wall Street firms' management, Caesars spent just $3.7 billion or an average of $0.46 billion per year, about 25% of the pre-buyout average annual capital expenditure.[23] And, from 2006 to 2018, Caesars nationally shed 24% of its workforce, going from 85,000 employees[24] to 66,000.[25]

iii. Supermarkets

Eileen Appelbaum and Rosemary Batt recently concluded an analysis of the supermarket industry that compared the performance of supermarket chains owned by private equity firms to those with other ownership structures.[26]

The research conducted by Batt and Appelbaum confirms that the PE ownership model and financial engineering that is often employed by PE owners leads to riskier capital structures at portfolio companies, makes it more difficult for them to withstand outside pressures - whether economic or from evolution in consumer preferences and technology - and can lead to worse outcomes for employees.

Since 2015 seven major grocery chains, employing more than 125,000 workers, have filed for bankruptcy. Some of the blame for these bankruptcies can be placed on competition from competitors like Walmart and Whole Foods (owned by Amazon). Another significant factor in many of these cases, however, was the PE owners who were behind all seven bankruptcies.[27]

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[21] Sujeet Indap, *What happens in Vegas . . . the messy bankruptcy of Caesars Entertainment*, Financial Times, Sep. 26, 2017, *available at* https://www.ft.com/content/a0ed27c6-a2d4-11e7-b797-b61809486fe2.
[22] Harrah's Entertainment, Inc., Annual Report (Form 10-K), at 35 (March 17, 2009). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000119312509055861/d10k.htm.
[23] Caesars Entertainment Corporation, Annual Report (Form 10-K), at 47 (Feb. 15, 2017). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000085833917000039/a2016q4cecform10-k.htm; Caesars Entertainment Corporation, Annual Report (Form 10-K), at 51 (March 17, 2014). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000085833914000014/a201310-k.htm; Caesars Entertainment Corporation, Annual Report (Form 10-K), at 38 (March 4, 2011). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000119312511056393/d10k.htm.

[24] Harrah's Entertainment, Inc., Annual Report (Form 10-K), at 8 (March 1, 2007). *Available at* https://www.sec.gov/Archives/edgar/data/858339/000119312507044315/d10k.htm
[25] Caesars Entertainment Corporation, Annual Report (Form 10-K), at 8 (Feb. 22, 2019). *Available at* https://www.sec.gov/ix?doc=/Archives/edgar/data/858339/000085833919000015/a2018q4cecform10-k.htm
[26] Rosemary Batt and Eileen Appelbaum, Private Equity Pillage: Grocery Stores and Workers At Risk, American Prospect, Oct. 26, 2018 *available at* https://prospect.org/article/private-equity-pillage-grocery-stores-and-workers-risk.
[27] *Id.*

PRIVATE EQUITY–BACKED CHAINS THAT WENT BANKRUPT

GROCERY CHAIN	P.E. SPONSORS	NUMBER OF STORES	NUMBER OF EMPLOYEES	BANKRUPTCY DATE
A&P (Food Basics, Food Emporium, Pathmark, Super Fresh, Waldbaum's)	Yucaipa Partners	296	28,500	July 2015
Fairway Market	Sterling Investment Partners	15	4,000	May 2016
Fresh & Easy	Yucaipa Partners	150	4,000	Oct. 2015
Haggen Food Grocery Store	Comvest Group	164	10,000	Sep. 2015
Marsh Supermarkets	Sun Capital	116	14,000	May 2017
Southeastern Grocers (BI-LO, Bruno's, Fresco y Más, Harveys, Winn-Dixie)	Lone Star Funds	>730	>50,000	Mar. 2009, Mar. 2018
Tops Markets LLC	Morgan Stanley	170	14,800	Feb. 2018

Batt & Appelbaum, Private Equity Pillage: Grocery Stores and Workers at Risk

Batt and Appelbaum found that, "private equity owners have extracted millions from grocery stores in the last five years—funds that could have been used to upgrade stores, enhance products and services, and invest in employee training and higher wages."[28]

The performance of supermarket chains owned by PE was often characterized by struggles to pay down excessive debt, financial engineering tactics to enrich PE owners at the expense of the businesses, and ultimately bankruptcy that left workers, suppliers, and other creditors taking hits. Employees were often thrown out of work and/or forced to take cuts to their retirement benefits. [29]

[28] *Id.*

[29] *Id.*

In September 2015 Haggen, Inc, a west coast grocery chain owned by Comvest Partners, declared bankruptcy after a failed expansion. According to Applebaum and Batt:

> Workers, vendors, suppliers, and landlords were losers in this story, but not Comvest... At the time that the P.E. firm agreed to buy the 146 stores, securities filings show it also reached a deal to sell the real estate underlying 20 of the new store locations for $224 million—and lease them back under a sale-leaseback agreement. It later engaged in sale-leaseback transactions for additional stores—for a total of 39 stores. Through these sales, Haggen made an estimated total of $300 million according to regulatory filings and real-estate documents—roughly equal to what it paid for the 146 stores... The unsecured creditors meanwhile—mainly laid-off workers, suppliers, and landlords—were owed roughly $100 million.

And in February 2018 Tops Markets declared bankruptcy:

> The northeastern chain of 170 grocery stores was bought out by Morgan Stanley Private Equity and Graycliff Partners in an LBO worth $310 million in 2007. Morgan Stanley pursued a number of LBO add-ons between 2007 and 2012, and then financed the buyout of the company, including all of its debt, by Tops management in December 2013. By that time, Morgan Stanley had loaded the company with $724 million in debt—more than twice the original purchase price. That included some $377 million in dividends that Morgan Stanley paid to itself and its investors—equal to 55 percent of the total debt that had accrued. This does not include advisory fees charged by Morgan Stanley nor the future interest payments that Tops had to shoulder...
>
> [T]he debt overhang left Tops with little wiggle room to reduce prices or resources to invest in store upgrades, new products, and online services needed to be competitive, as it reported itself in its bankruptcy filing. At the time of the bankruptcy, it had 14,800 employees... The company used the bankruptcy process to substantially

b. Excessive leverage

Leveraged buyouts (LBOs) are a traditional strategy employed by PE. An LBO can be thought of as a financing technique used to acquire an operating company using a small amount of cash and a large amount of debt that resides on the books of the target company. PE GPs usually put a small amount of their own money towards the down payment, 1-3%. The remainder of the equity investment is provided by investors such as pension funds and wealthy individuals. In a typical buyout, around 30% of the purchase price is paid as equity, or cash, and 70% is debt financing.[30]

When a PE fund buys a company, the company is responsible for paying down loans, not the GP or the investors. Loan payments are paid out of the company's earnings and if the company cannot make the payments, the PE fund is not responsible for the company's debts. It is common practice for a company acquired in an LBO to take out additional loans shortly after the acquisition to reimburse the PE GP for a portion of the down payment or pay a dividend in what's called a "dividend recapitalization."

As discussed above, the debt servicing burden that excessive leverage imposes on a company often forces the company to forego investments to make the company more competitive and provide family-sustaining wages and benefits to its workforce.

Recent increases in the issuance of leveraged loans, which are often used to finance LBOs, are raising concerns among regulators domestically and globally.[31] In the past five years, the value of outstanding leveraged loans has nearly doubled to $1.19 trillion.[32] Late last year, the Federal Reserve issued a Financial Stability Report which raised concerns about high levels of corporate debt and the increase in risky lending practices.[33] The report stated, 'lenders have become more willing to extend loans with fewer credit protections to higher-risk borrowers. Moody's Loan Covenant Quality Indicator suggests that loan covenants are at their weakest levels since the index began in 2012...' [34]

In October 2018, Former Federal Reserve Chair Janet Yellen raised concerns that the leveraged lending market could create systemic risks. She said, "I am worried about the systemic risks associated with these loans...There has been a huge deterioration in standards; covenants have been loosened in leveraged lending."[35]

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reduce the pension benefits for [employees] by withdrawing from [union] defined benefit pension plans and replacing them with 401(k) plans.

[30] *Id.*

[31] Jim Puzzanghera, *Remember the subprime mortgage mess? $1.2 trillion in risky corporate debt is flashing similar warning signs*, LA Times, Jan. 20, 2019, *available at* https://www.latimes.com/business/la-fi-corporate-debt-risks-20190120-story.html.

[32] *Id.* See also *Risk-off shift brings banks back to leveraged loan market*, S&P Global Market Intelligence, Apr. 8, 2019, *available at* https://www.spglobal.com/marketintelligence/en/news-insights/trending/eCZ7eZ4RH8dpwSArc_UCbQ2.

[33] Board of Governors of the Federal Reserve System, *Financial Stability Report*, Nov. 2018, *available at* https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf.

[34] *Id at 12.*

[35] Sam Felming, *Janet Yellen sounds alarm over plunging loan standards*, Financial Times, Oct. 25, 2018 *available at* https://www.ft.com/content/04352e76-d792-11e8-a854-33d6f82e62f8.

c. Investors in private equity

US pension funds have an average target allocation to private equity of 8.6% of total assets.[36] In many situations, pension plans are under pressure to make up for insufficient employer contributions by chasing riskier investments that could produce greater returns. PE funds advertise that they have the ability to provide those returns. Unfortunately, the opacity, illiquidity and high fees associated with PE add to the risks of the investment and the difficulty in achieving returns sufficient to justify those risks.

The lack of transparency into PE makes it difficult to analyze the accuracy of claims that PE investments outperform other asset classes. In addition, PE managers do not use traditional metrics to report returns. The CFA Institute has explained that typical methods for comparing performance "work well (at least from a statistical perspective) only for those instruments that are publicly traded and are highly liquid. This is a major problem for private equity (PE) investments as they are not only 'private' and illiquid but also exhibit serious smoothing issues because of subjective appraisals and valuation lags."[37]

In December 2018, the CFA Institute published, "Private Equity: The Emperor Has No Clothes." The piece examined different models of private equity returns and concluded, "Exposure to small caps likely explains private equity returns. Liquid alternatives to private equity can be created simply by buying small, cheap, and levered stocks… [Locked-up capital] keeps investors from redeeming their funds at market lows and helps private equity firms weather storms like the global financial crisis. But the same fund structure can be replicated through public equities at a fraction of private equity fees."[38]

PE is characterized by high fees that take away from investors' returns. The fee structure, known as "2 and 20," means that the fund manager gets 2% annually of the total amount of assets under manager plus 20% of the return on any investment.

PE investments are illiquid, and therefore pose greater risks for investors. The average life of a fund is 10 to 13 years.[39] The secondary market for interests in PE funds is very limited. The total transaction volume in the secondary market in 2018 was estimated at $72 billion.[40] To put that in perspective the industry has around $4.1 trillion in committed capital – less than a 2% turnover rate.[41] Once an investor buys into a fund, it is very difficult to get out before the fund sells off all the companies in the portfolio.

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[36] American Investment Council, Public Pension Study, May 2018 *available at* https://www.investmentcouncil.org/wp-content/uploads/2018-public-pension-study-final3.pdf.

[37] Prasad Ramani, *Evaluating Private Equity Performance: PME vs. Direct Alpha*, Enterprising Investor, CFA Institute, Jul. 23, 2014 *available at* http://blogs.cfainstitute.org/investor/2014/07/23/evaluating-private-equity-performance-pme-vs-direct-alpha/.

[38] Nicolas Rabener, *Private Equity: The Emperor Has No Clothes, Enterprising Investor*, CFA Institute, Dec. 3, 2018 *available at* https://blogs.cfainstitute.org/investor/2018/12/03/private-equity-the-emperor-has-no-clothes/ .

[39] Robert Harris, Tim Jenkinson and Steve Kaplan, *Private Equity Performance: What Do We Know? Available at* http://faculty.chicagobooth.edu/steven.kaplan/research/kpe.pdf

[40] Coller Capital, *The Private Equity Secondary Market*, Coller Capital Ltd. 2019 *available at* https://www.collercapital.com/sites/default/files/Coller%20Capital%20%E2%80%93%20the%20private%20equity%20secondary%20market_0.pdf.

[41] *Press Release: Private Equity Industry Grows to More Than $3tn in Assets*, Preqin, Jul. 24, 2018 *available at* http://docs.preqin.com/press/PE-Assets-Jul-18.pdf.

The Dodd-Frank Act required PE fund managers to register with the SEC for the first time and submit to periodic examinations. After the first round of exams, the then SEC Director of the Office of Compliance Inspections and Examinations Andrew J. Bowden revealed that extensive abuses had been uncovered. Bowden said in a 2014 speech, "When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time."[42]

The minimal reporting and examination requirements instituted by Dodd-Frank revealed an industry where abusive practices towards investors were common practice. More must be done to rein in these abuses.

d. PE solutions

The private equity model exists and is remarkably profitable for the GPs who run the funds due to a series of loopholes and carveouts in securities, bankruptcy and tax law. Exemptions in the securities laws allow PE firms to avoid the disclosure requirements and SEC oversight applicable to other pooled investment vehicles, like mutual funds, of a similar size and impact in terms of the number and relative wealth of the individuals whose retirements and job security depend on their performance. The bankruptcy laws allow GPs to load companies with debt, pay themselves dividends, and walk away without any responsibility if the company ends up in bankruptcy. And, PE GPs take advantage of tax loopholes such as the carried interest tax loophole and tax benefits for monitoring fee abuse.

There is no public interest reason to provide incentives that encourage and reward private equity buyouts. In fact, I would argue, that the public interest demands that policymakers eliminate loopholes, carveouts and privileges that feed abusive leveraged buyouts and strongly encourage the Committee to consider this set of issues.

6. Conclusion

In conclusion, I commend the Subcommittee for taking up the topics being considered at today's hearing. The message, for too long, has been that policymakers must choose between policies that protect shareholders' interest and those that protect workers' interests. Investors know that economic stability is good for investment outcomes. Over the long-term, economic stability requires broad-based economic growth and shared prosperity.

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[42] Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Spreading Sunshine in Private Equity, May 6, 214 *available at* https://www.sec.gov/news/speech/2014--spch05062014ab.html.

Testimony of Abigail E. Disney
President of Fork Films,
Co-Founder / Chairperson of Level Forward
Before Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
U.S. House of Representatives
On
Promoting Economic Growth: A Review of Proposals to Strengthen the Rights and Protections for Workers

May 15, 2019

Thank you Madame Chair Representative Carolyn Maloney for convening this hearing on Promoting Economic Growth: A Review of Proposals to Strengthen the Rights and Protections for workers. Thank you, as well, Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee, for inviting me to testify. The subject we are here to discuss is critical to the future of our country.

I am here to help shed light on the problem of excessive executive compensation and the injustice of the contrast between that compensation and the low wages and poor conditions of those that work at the bottom of the pay scale. These problems have been growing over the decades and will continue to worsen, and have deeply negative consequences for our great nation.

My mission is to use the voice I have to speak for those whose voices would otherwise not be heard. I hope to enlighten and engage those in powerful positions and inspire them to make change—starting with this committee as well as representatives of various other companies and organizations.

I do not speak for my family but only for myself.

I have no role at the company, nor do I want one.

I hold no personal animus toward Bob Iger nor to anyone else at the Walt Disney Company.

I have repeatedly insisted, in fact, that he and the rest of management at Disney are brilliant and that performance-based compensation for them is totally appropriate.

The questions I am raising are simply "is there such a thing as too much?" "Does what a CEO gets paid have any relationship to how much his janitors and wait staff and hotel workers are

paid?" And, "Do the people who spend a lifetime at the lowest end of the wage spectrum deserve what they get, or does every person who works full-time deserve a living wage?"

I know a little something about the dynamics of money. It is a lot like the dynamics of addiction.

Alcohol, like money, can be a harsh and demanding task master; once one glass of wine becomes normal, it demands a second, and then a third. Returns diminish, and more is always, eternally required. That is why billionaires leave terrible tips, heirs rankle at the idea of estate taxes, and wealthy old men go to their graves grasping for yet more. (Does the name "Rosebud" ring a bell?)

I believe that there is such a thing as too much money. And, to be yet more heretical, I believe it is possible to say no to more.

As an heiress with a famous last name I've been granted a free pass into the places where wealth is unapologetically flaunted. I've watched as, over the last few decades, the wealthy have steadily self-segregated into ever more restrictive and lavish spaces. In those spaces, even as they discuss the scourge of poverty, they guarantee that they will never have to look a gross inequity in the eye. In so shielding themselves, they have lost the ability to tolerate discomfort, and so work ever harder to keep their delicate sensibilities out of harm's way.

I've seen what excess looks like in the form of the private planes parked chock a block at posh conferences about global warming, where no one so much as nods at the grotesque irony of such a thing.

I've lain in the unnecessary queen size bed of a 737 big enough to carry hundreds but designed to accommodate no more than a dozen.

I have seen it in 85 million-dollar mansions dotting the Hamptons—empty— I have watched children decked out in designer outfits expensive enough to fund a whole family's healthcare for a year and I've been a guest in homes with toilets that clean your backside on your behalf. (Yes, there is such a thing, and yes, it's really gross.)

It is time to pull back the curtain on this garish life and ask ourselves how high a handful should soar as the rest of us watch the American Dream collapse for a large majority of working people?

This is not just a question of what is moral or what is right. There's an important economic case to be made for addressing inequality across the spectrum. In tolerating such extreme unfairness, we have begun to cannibalize the very people that make this economy thrive. After all, no middle class, no Disney.

And yes, low unemployment is great, unless the only jobs available are low-paying jobs with no benefits, no hope of retirement, no respect.

Offering education to employees is also great but sidesteps the issue at hand. You do not pay a worker for what they might or might not eventually do tomorrow. You pay them for the work they've done today. And you pay them fairly for it.

Calling this a "starter job" reveals a presumption of privilege that bears no relationship to the reality of most college graduates who do not have well-resourced parents with money to supplement their income, and who do not have the luxury of taking a job that will offer a wage dwarfed by the enormous debt they've incurred getting the education most of their parents got either almost or totally free of charge.

Philanthropy is often offered as the answer to the problem of inequality. While wonderful, philanthropy is not the answer because these problems are not a question of personal choices or individual behaviors. They are the consequences of structures that create and then enforce a deeply unfair and inequitable society.

Philanthropy offers a man a fish, even teaches a man to fish, but persistently fails to ask why the lake is running out of water, or why the man does not know how to do what his ancestors knew perfectly well how to do and did every day.

Philanthropy supports art and education and many indispensable cultural institutions, and we should all be grateful to the donors who take this job on. I do not question the generosity it entails.

Philanthropy that helps the poor is in many ways an even more admirable form of the art, because it offers benefits that the donor cannot possibly enjoy him or herself.

But in attempting to address the consequences of deeply unfair economic structures—the very structures, in fact, that make philanthropy possible—even the most generous charitable giving uses the master's tools that can never dismantle the master's house, to borrow a metaphor from Audre Lorde.

Even if philanthropy could face its fear of asking where all the money is coming from, it still cannot work at large enough of a scale or in enough unison to address the problems I am talking about. Even the largest philanthropy is dwarfed by government programs like Head Start, Food Stamps, Social Security and Medicare, each of which has proven effective and has already lifted many millions out of poverty.

At Disneyland in Anaheim, workers had to fight for years to get their minimum wage raised to $15/hour, all while the cost of living in Anaheim continued to rise. Studies show that today a living wage in Anaheim is closer to $24/hour. Studies show, in fact, that $15/hour is not a livable wage in most places in the US.

All this for the very people my parents and grandparents taught me to revere and treat with the utmost respect. The world of low wages and wondering where your next meal might be coming from is, after all, where my own grandparents got their start. I vividly remember my grandmother telling me about the many mornings she left for school in Kansas wondering how

she would be able to feed her siblings when she got home. She left high school at 16 to support her family and worked damn hard to do that.

I can say with total certainty these are not the values my family taught me.

I have spoken up because I am uniquely placed. As an heir to Disney's legacy and yes, no small share of its money, I feel a special responsibility to speak. As my life has brought me into relationship with many friends and colleagues who have been as unlucky at birth as I've been lucky, the contrast between their lives and my own is hard for me to bear.

I am also uniquely placed because I am not just any heir, and because Disney is not just any company. Disney is not US Steel. Nor is it Procter and Gamble, or Apple, or Chevrolet or any other iconic American brand. The Disney brand is an emotional one, a moral one, I would even say it is a brand that suggests love.

I have spoken up as a Disney about the Walt Disney Company not to pick a fight, but to put those moral undertones and all that love to constructive use. Because this is a moral issue. And it is so much bigger than just Disney. For too long the business community has brushed aside moral considerations as beneath them—naive, childlike, irrelevant. For too long it has been anathema in the business world to be tagged with the label of "do-gooder."

And when I call out the problem presented by any man, however brilliant, walking away with 65 million dollars after only grudgingly offering his own employees a wage that cannot support a single person much less a family, I know it will get a lot of attention, and hopefully jar a lot of sleepwalkers into consciousness.

I spoke out about Disney in spite of the fact that I am well aware that Bob Iger is by far not the worst offender as far as excessive compensation goes, but because I want to bring attention to the issue of inequality more broadly and to shine a light on all that we have gradually allowed ourselves to become accustomed to in the name of this fundamentalist version of capitalism we currently practice.

It wasn't always this way. It was made this way by people and therefore by people it can be changed.

This is, oddly enough, not an issue that divides red from blue. Not, at least, at the highest levels. Many an executive who calls himself liberal or donates to candidates whose rhetoric would seem to indicate a care for the poor, fails to bat an eye when offered his or her princely compensation.

Many of these men and women are perfectly nice people. But the hypocrisy has been so normalized I don't think most of them even see it.

Disney itself is uniquely placed to lead us out of this quagmire if its management so choose. Disney led when it offered benefits to same sex partners. It led when it began to foreground environmental concerns in all of its divisions. It led when it began consciously to

focus on the hiring and promotion of women, of people of color and other groups. On this issue, Disney could lead once more.

Disney, after its merger with Fox, will be the largest media entity the world has ever known.

All the company lacks to lead, ironically enough, is the imagination to do so.

I want to make it clear that I have raised all of these issues with Bob Iger in the past, quietly and politely and behind the scenes with decorum and deference. I was quickly and condescendingly brushed aside. A public position is the only choice I have left to try to influence this.

What could Disney do? It could raise the salary of its lowest paid workers to a living wage. There are plenty of economists who would be only too happy to help them figure out what that living wage is.

And when you cry out that they can't make a profit while paying a living wage, keep in mind that right now the company has never been more profitable, and is paying record compensation out to management. I hope you'll forgive me if that claim gets a cynical groan from me. This is merely a question of priorities.

Here are some more thoughts on what it is well within Disney's power to do. Many of these are ideas given to me by people who work low wage jobs at Disneyland when I spoke to them last year.

Disney could take half of this year's enormous executive bonuses, all of which are a fraction of revenues, and place them into a dedicated trust fund which could help workers with emergency needs like insulin, housing, transportation and child care.

Disney could rehabilitate moribund housing near its parks to ensure people do not have to drive three hours every day to get to work.

Disney could restore the employee stock option program for all employees, not just management.

Disney could restore the right that workers once had to get into the park for free, since as things now stand, they cannot afford to bring their own families to the happiest place on earth.

Disney could make food available to employees. Many employees currently survive on food stamps and yet are required to throw away huge amounts of food on the job. I cannot imagine how that feels.

Disney could hold two or three seats on the board for employee representatives, to be elected by their peers. They, being well versed on what's going on the inside of the company, could probably contribute more effectively to board discussion than yet any CEO from an unrelated industry anyway.

Because the board is currently made up entirely of people who either are or hope one day to become CEO's, it is hard to imagine any kind of compensation getting much push back.

Disney could, in the future, pay attention to the relationship of the CEO's compensation to the wage of, not its median wage worker, but its lowest full-time worker.

This leads me to respectfully suggest that the Human Capital Disclosure Bill needs one tweak. On the whole the bill is important and worthy and should pass but here's the thing. Pegging the ratio of the CEO's compensation to that of the median worker is not a reliable metric. It does not reflect that in some sectors, like banking, median pay is much higher than in others.

That means that men like JP Morgan Chase Jamie Dimon are not getting called on the carpet for this problem even if they are just as guilty of driving their own workers' wages down while walking away, year after year, with obscene amounts of money. They might in fact be even more culpable, since they've spent years as some of the primary architects of the very financial systems that have blithely encouraged the downward pressure on not just salaries, but benefits, vacations, parental and family leave, retirement benefits and more.

And while we are on the subject of Jamie Dimon, it is useful to remember how we all recently watched him struggle to answer a simple question Representative Porter posed to him about the entry level wage at JP Morgan Chase.

His demeanor in that moment was that of a man who'd never pondered the question before, nor worked with anyone with the temerity to ask him about it. While he floundered for an adequate response that would ultimately never come, he looked like a man bent on never acknowledging one very obvious and important fact: that in a year of record profits and 8 figure compensation at the highest levels, the pay at his bank is way out of whack and further, that if someone working full time for him cannot afford even the most basic necessities without running up a crushing amount of life-destroying debt, something needs changing, and fast.

There is nothing inherently wrong with an 8-figure payoff—unless there are people at the same company rationing their insulin. Then it is simply unacceptable. And the CEO has a moral obligation to know what life is like for the low wage workers under his own roof.

Comparing a CEO's compensation with a median worker's wage renders the experience of low wage workers invisible and implies that they are irrelevant to the well-being of the very company they labor to support. It implies that the fates of the CEO and his lowest wage worker are unconnected. It is this feeling of disconnection that enables management to repeatedly ignore conditions deteriorating right under their noses.

No CEO, no matter how brilliant, is any better or more important than a janitor. No one is too good to scrub a toilet. To leave the lowest paid full-time worker out of the equation is to imply that some people should be invisible and disregarded.

The work that needs doing is not all up to Disney and, again, Disney is a long way from being the worst company in this regard. Lest you doubt this, have a look at the fortune Jeff Immelt amassed while driving share prices down more than 30% during his tenure at General Electric.

We need to change the way we understand and practice capitalism. We need to put people ahead of profits once and for all. Yes, leadership has a fiduciary obligation to their shareholders. But they also have a legal and moral responsibility to deliver returns to shareholders without trampling on the dignity and rights of their employees and other stakeholders.

This moment has never been simply about excessive compensation. But outrageous payouts do get us thinking about business practices that are unsustainable, irresponsible and morally corrosive.

We need to change our assumptions. If you cannot afford to pay a living wage, you cannot afford to hire a worker. If you cannot afford to stop dumping chemicals into the river, you cannot afford to be in the chemical business. If you cannot afford to replace a key employee who has terrorized and harassed his peers, you cannot afford to have him there in the first place.

We need to change our metrics so that they better reflect our values. We need to look at the ratio of a CEO's compensation to that of his lowest-paid, full-time worker, because that person is just as much a part of the company as the median paid worker and just as much a part of the company as the CEO. Let's choose to tether their fates and make it more difficult to leave that low paid worker out of consideration when any important decisions get made.

It is time to say, "enough is enough." It is time to bring a moral and ethical framework back to the way we discuss business. It is time for business leaders to recognize that they have altered the nature of this communal project we call the United States of America, and that now they must hold themselves accountable to their fellow citizens. And if not, then we must hold managements to account on citizens' behalf.

"We Manage What We Measure":
Testimony to the U.S. House Committee on Financial Services

May 15, 2019
by Nili Gilbert

Good morning, everyone. My name is Nili Gilbert, and I am a Co-Founder and Portfolio Manager of Matarin Capital Management, an institutional asset management firm based in New York City. I also speak to you today as the Chair of the Investment Committees of both the David Rockefeller Fund and the Synergos Institute, as a World Economic Forum Young Global Leader, and as a permanent member of the Council on Foreign Relations and the Economic Club of New York.

Before I continue, I would like to qualify my remarks. I am speaking today only for myself and not for Matarin Capital Management or its staff, and my remarks constitute neither recommendations nor solicitations for any investment.

I am testifying in support of H.R. ___ , "to amend the Securities Exchange Act of 1934 to require issuers to disclose information about human capital management in annual reports."

The Power of Information

Asset owners from Wall Street to Main Street, representing tens of trillions of dollars around the world, and many asset managers like me, who serve them, are increasingly seeking to better understand certain material non-financial information about the companies of which, as shareholders, we are owners.

This call to require issuers to disclose information about human capital management in annual reports is rising because better insight into the material non-financial information of individual companies will help us to better understand and respond to the broad macroeconomic environment in which we all are operating. We can think of the country's macro-economy as being an amalgam of the individual institutions and actors within it. So, with clearer information about individual companies' human capital management practices, we could gain a clearer picture of the environment for American labor and productivity overall, at a pivotal moment for both of these economic drivers.

This call is also rising because we know that better information can lead to better investment results. An investor in possession of perfect information would be the best investor in the world, and an investor in

possession of no information should expect results no better than a coin toss. Better investment results could buoy our country's individual savers and pension funds, supporting our country's retirement system at a critical time; better investment could support our nation's education system through its school's endowments, support our civil society through its foundations and endowed nonprofits, and beyond.

H.R. ___would implement a rulemaking petition to the SEC which was put forward by a group of investors called the Human Capital Management Coalition, representing $2.8 trillion in assets, including public pensions and state Treasuries from California, to Illinois, New York, Ohio, Oregon, and Pennsylvania, as well as labor unions representing millions of American workers and their pension funds, and several others.[1] The petition calls on the SEC to require human capital disclosures from public companies. In particular, H.R. ___ would require companies to report information on their workforces' skills, culture, stability, productivity, and safety, among other factors, which may be important to investors in assessing the long-term value of the companies that we invest in.

Many of those seeking deeper data disclosure are owners of these companies, as shareholders, extending beyond the specific asset owners, asset managers and labor unions represented by this petition. For example, the Sustainable Accounting Standards Board (SASB) has called for similar data in its detailed "Materiality Map" of non-financial data.[2]

The specific data items requested in this bill have been culled from the Embankment Project for Inclusive Capitalism (EPIC), an 18-month, multi-stakeholder, multi-sector project in which 32 companies representing $30 trillion in assets came together to identify a list of human capital management practices that both the corporate leaders and the market participants who participated in the study found to be value creating.[3] The EPIC project researched over 400 different human capital metrics to develop a recommended list of just forty in its formal report. From that initial list of forty items identified, the bill H.R. ___ that we are discussing today focuses on just nine.

These nine items have been put forward with the expectation that they would not be too onerous or expensive for companies to collect – many companies are already tracking them, as well as with the

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[1] HCMC. "Rulemaking Petition To Require Issuers To Disclose Information About Their Human Capital Management Policies, Practices, and Performance." *SEC*, Human Capital Management Coalition, 6 July 2017, www.sec.gov/rules/petitions/2017/petn4-711.pdf.
[2] "SASB Materiality Map." *SASB Materiality Map*, SASB, 2018, materiality.sasb.org/.
[3] "Business Leaders Unite To Create Long-Term Value Measures." *Epic-Value*, Coalition for Inclusive Capitalism, 2018, https://www.epic-value.com/static/epic-state-of-support-9728b8997666e8c5979b3202e8713297.pdf.

belief that this information would be broadly relevant across a wide group of companies, and with the support of studies which have shown these data items to be material.[4]

Reports from the Field

I come to you today as a traditional, financial-first, data-driven investor, to give you a sense of how lack of data availability is playing out on the ground. Our clients are increasingly interested in identifying and analyzing non-financial risks and opportunities in their portfolios, and although we are actively seeking ways to respond to their requests, we are often running into limitations when it comes to finding good data. And of course, investors like me are also always motivated to turn over any new stones that may help us to make even more insightful decisions about the companies we are investing in. That's our job.

We understand that human capital is an increasingly important part of companies' success – especially here in the US, where innovation is such an important driver of our economic growth and of the success of the country's largest companies. By way of example, the four largest sector weightings in the S&P 500 Index today are Technology, Health Care, Financials and Communications, all of which rely a great deal on talent and innovation for their success.

For many investors, when we are doing our analysis, we are seeking to compare companies side-by-side (where comparisons are appropriate), using data that has been collected and measured according to the same standards, to avoid any apples-to-oranges comparisons or "garbage in, garbage out" situations that could lead to poor or nonsensical results within our investment analysis. Regulatory standards have proven very effective in offering frameworks such as the Generally Accepted Accounting Principles that investors around the world rely on for receiving sound financial data that we can trust on an ongoing basis.

It may sometimes be easy to forget that until the 1930s, even the disclosure of *financial* data about publicly-traded companies was not standardized. Companies could calculate and report their results in any way that they wanted. The faulty and misleading information that resulted from this contributed to the stock market crash of 1929, and the Great Depression. As a result, market participants and regulators came to realize they needed better information. The Generally Accepted Accounting Principles that we rely on today thus began to be established with legislation such as the Securities Act

[4]Bernstein, Aaron, and Larry Beeferman. "Corporate Disclosure of Human Capital Metrics." *Labour and Worklife Program*, Harvard Law, Oct. 2017, lwp.law.harvard.edu/files/lwp/files/pension_paper_corporate_disclosure_of_human_capital_metrics_102317.pdf.

of 1933 and the Securities Exchange Act of 1934, which the bill that we have before us today seeks to expand.[5]

Today, when it comes to human capital and other non-financial metrics, the data and disclosures that would be required to evaluate US companies on a broad scale are in a similar state to financial data before the Great Depression. The data are "fragmented," meaning that they are available only for a limited number of companies.[6] Additionally, whatever data is available may not even be "clean," resulting, for example, from a lack of common standards about how the data should be collected and reported.

Due to the fact that companies are not making standardized disclosures on these issues, many investors are forced to use data prepared by third-party data providers in order to evaluate non-financial information, which is by definition more subjective and less standardized. This third-party data is also in many cases too expensive for the average individual investor to consider accessing, which has the potential to put them at a disadvantage relative to large financial firms.

What's more, you'll find professional firms whose preference, rather than to buy data from third party providers, is whenever we can to gain access to clean, "raw," objective data about companies in our investment universe, and then to use those building blocks to create our own analysis and draw our own conclusions. Investors may all start with the same raw data, but then find different ways to use it, and draw different types of conclusions. This type of uniqueness in analysis is what drives the markets as we know them. It drives a good deal of the so-called "price discovery process" across asset classes, which helps our markets to be more efficient. However, unfortunately, it is very hard to find the necessary data required to apply this type of analysis in the important field of human capital, due to limited availability. And it seems highly unlikely that this situation will change without the support of regulation.

It is also foreseeable that standardizing disclosures could actually help American companies by lowering their burden of reporting material non-financial information over time. Currently, over 150 ratings systems exist, covering over 10,000 sustainability performance metrics that are trying to fill in the gap that is left by the lack of a generally accepted standard.[7] Corporate leaders have begun expressing

[5] "The Comprehensive Guide to Understanding GAAP." What Is GAAP, Accounting.com, 26 Apr. 2019, www.accounting.com/resources/gaap/.

[6] Comment of the Sustainability Accounting Standards Board on "Concept Release: Business and Financial Disclosure Required by Regulation S-K," dated July 1, 2016, https://www.sec.gov/comments/s7-06-16/s70616-25.pdf) (hereinafter, "S-K Concept Release".

[7] Hower, Mike. "Could Sustainability 'Survey Fatigue' Launch A $1 Billion Industry?" GreenBiz, GreenBiz Group Inc., 2 Apr. 2015, www.greenbiz.com/article/gisr-program-cuts-core-esg-research-and-ratings.

"survey fatigue" from having to complete scores of reports that are all requesting disparate data. Standardization, in the future, could help to lower this burden.

It is also interesting to consider that expanded data disclosure may improve companies' business results by lowering their cost of capital, as greater transparency lowers perceived risk and allows investors to feel more confident in our analysis.[8] Lower borrowing costs for American corporations would have the potential to act as an economic stimulus.

Living in a Material World

What makes us think that data about human capital management is "material," even though it is non-financial?

During 2017 Harvard Law School's Forum on Corporate Governance and Financial Regulation published a review of 92 studies that measured the impact of human capital management policies on corporate performance and concluded that that there is sufficient evidence of human capital materiality to financial performance to warrant inclusion in standard investment analysis.[9] This is just one of several academic and financial industry studies which draw similar conclusions. Of course, market actors will want to work with the data to draw our own applications and conclusions, if provided with the raw informational inputs.

Traditional financial data helps us to be informed about companies' physical tangible assets, such as property, plant and equipment, but over the course of the past several decades, an increasing portion of American companies' assets are now *intangible* – for example, talent and the patents that it generates. So, these findings on the materiality of human capital management data should strike us as intuitively correct.

During 2017, Matarin Capital published a thought piece about the US economy becoming more 'asset-light', which was entitled "Less is More".[10] In this piece, we highlighted the five largest companies by

[8] Naumer, Hans-Jörg. Added Value or a Mere Marketing Tool? What Does ESG Mean for Investments?Allianz Global Advisors, Dec. 2017, hk.allianzgi.com/-/media/allianzgi/ap/hongkong/pdf/en/investment-themes/201712-esg-hk-en-final.pdf.
[9] Bernstein, Aaron, and Larry Beeferman. "The Materiality of Human Capital to Corporate Financial Performance." *Labour and Worklife Program*, Harvard Law, April 2015, https://lwp.law.harvard.edu/files/lwp/files/pension_paper_materiality_of_human_capital_042015.pdf.
[10] "Less Is More." *Matarin Capital Quarterly Newsletters*, Matarin Capital, 2017, matarin.com/wp-content/uploads/2013/02/Q2-2017-Less-is-More.pdf.

market cap in the US at that time (which remain the five largest companies today) and compared these to the five largest companies in the US thirty years ago. What we discovered is that back in 1987, one unit of physical assets, as measured by net property, plant and equipment, supported only 2 times its value in the stock markets. (For example, applying this ratio, a company with $10 billion in physical assets would have approximately $20 billion in stock market capitalization.) Today, among our 5 largest companies in the US, that same amount of property, plant and equipment supports 28 times its value! (Applying today's ratio, a company with that same $10 billion in physical assets would today have a $280 billion market cap, instead of $20 billion.) This tells us that there is something new that is driving value in the US markets, to a great degree.

	2017				
	Market Cap	Net PPE	Mkt Cap/PPE	Book Value	Price/Book
Apple	750	27	**28**	132	**5.7**
Alphabet	643	34	**19**	139	**4.6**
Microsoft	532	18	**29**	69	**7.7**
Amazon	463	29	**16**	19	**23.9**
Facebook	438	9	**51**	59	**7.4**
		Average	**28**		**9.9**
US Market			**4**		**3.1**
	1987				
	Market Cap	Net PPE	Mkt Cap/PPE	Book Value	Price/Book
IBM	98	22	**5**	35	**2.8**
Exxon	66	50	**1**	33	**2.0**
GE	50	10	**5**	16	**3.1**
AT&T	30	20	**1**	14	**2.2**
Du Pont	29	16	**2**	13	**2.2**
		Average	**2**		**2.4**
US Market			**2**		**2.1**

Data as of June 30, 2017. Source: Matarin Capital, Compustat, FactSet

Similarly, the group Ocean Tomo published a report highlighting the fact that tangible assets had fallen to just 13% of the market value of the S&P 500 in 2015, compared with 87% of the S&P 500's value in 1975.[11]

The Weightless Economy

In his book *The Map and the Territory*, former Federal Reserve Chair Alan Greenspan reflects on his time as a young economist in the 1950s, when the change in the *physical weight of goods* produced in the

[11] "Annual Study of Intangible Asset Market Value from Ocean Tomo, LLC." *Annual Study of Intangible Asset Market Value from Ocean Tomo, LLC*, Ocean Tomo, 15 Mar. 2015, www.oceantomo.com/2015/03/04/2015-intangible-asset-market-value-study/.

U.S. was a popular measure for tracking our economic growth. [12] He recalls visiting Pittsburgh back in those days and hearing the coke oven ash crunching under his feet – the sound was kind of a symbol of American economic greatness, at the time. Greenspan then observes that the U.S. economy has *not grown at all since the late 1970s* by this measure of the physical weight of production. He says that we have substituted "ideas for physical volume," and "intellectual for physical labor." Today, a sign of American economic progress is that the goods that we are producing are getting smaller and lighter, not bigger or heavier. And some of our most important assets are weightless.

As the physical weight of goods produced in the US economy has fallen, the value and importance of our human capital has risen. The next frontier for investment and economic analysis will be to understand these dynamics, and a crucial next step in this will be for companies to disclose better data about their human capital management.

The Future of Work

We are living in a moment in history in which the role of labor in the production process is in flux. With the rise of robotics, automation, and artificial intelligence, there is an open question about how and to what extent companies will use human workers going forward. There is consensus that the effects will be broad and lie just around the corner.[13,14] One common way of thinking is that we may be able to improve outcomes by re-training workers to be able to work collaboratively with machines, to improve results on both sides. But another way of thinking suggests that many workers will be displaced entirely. A recent Brookings Institution report suggests that 36 million Americans today have jobs in which 70 percent or more of their tasks could soon be performed by machines using existing technology.[15] In addition to understanding the sheer number of jobs that are at risk, we need to consider the nature of those jobs. While autonomous vehicles and sensor-based grocery stores clearly threaten drivers and

[12] Greenspan, Alan. *The Map and the Territory: Risk, Human Nature, and the Future of Forecasting*. Penguin Group USA, 2013.
[13] "Artificial Intelligence, Automation, and The Economy." *White House Archives*, Executive Office Of the President, Dec. 2016, obamawhitehouse.archives.gov/sites/whitehouse.gov/files/documents/Artificial-Intelligence-Automation-Economy.PDF.
[14] Lee, Kai-Fu. "How Artificial Intelligence Job Displacement Will Affect The Worldwide Economy." *Forbes Innovation*, Forbes, 9 Oct. 2018, www.forbes.com/sites/quora/2018/10/09/how-artificial-intelligence-job-displacement-will-affect-the-worldwide-economy/#1e5c29b91f52.
[15] Associated Press. "Over 30 Million U.S. Workers Will Lose Their Jobs Because of AI." *Economics and Politics*, MarketWatch, 24 Jan. 2019, www.marketwatch.com/story/ai-is-set-to-replace-36-million-us-workers-2019-01-24.

cashiers, less obvious is the threat to accountants, financial advisors, lawyers, doctors and other professional jobs.[16]

This is an issue of great national importance. By gathering clearer data today about issues such as worker skill gaps and training, workforce stability and turnover, and workforce productivity trends, we would have the information resources required to prepare for the changes of tomorrow. We could gain better understanding of how individual companies are strategically preparing for these rising competitive forces. Additionally, by looking across all American companies in total, we could gain a better understanding of our whole economy's preparedness for this shift. It seems likely that this will become an issue of rising importance in the coming years, both in my work, and in all of yours.

"We Manage What We Measure"

I know that within these historic walls, there have been many important debates about how American institutions should behave. What should they be doing; how should they act; for and with whom? But that is not why I have come here to testify before you today. I, and other market participants like me, are only seeking information when it comes to data disclosure, not prescription.

To a certain extent, I believe that the markets have the potential to adapt themselves to the emerging realities of the present and the future, but as the old adage goes, "We Manage What We Measure." Please give us the tools that will be required to measure even more of what matters, for generating successful investment returns for our people and our institutions, and for creating a market that is purpose-built for the bright future that we all dream of for America's economy and its citizens.

Thank You. I look forward to your questions.

[16] Yang, Andrew. "We're Undergoing the Greatest Economic Transformation in Our History." *Yang2020*, 19 Apr. 2019, https://www.cnn.com/2019/04/14/opinions/greatest-economic-transformation-andrew-yang/index.html

Via Hand Delivery

May 14, 2019

The Honorable Carolyn B. Maloney
Chair
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Bill Huizenga
Ranking Member
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Re: May 15, 2019 Hearing entitled: "Promoting Economic Growth: A Review of Proposals to Strengthen the Rights and Protections for Workers"[1]

Dear Madam Chair and Ranking Member Huizenga:

I am writing on behalf of the Council of Institutional Investors (CII) to express our appreciation for holding the above referenced hearing and to provide you with our views on two legislative proposals on corporate governance related topics that are of great interest to our members and that are expected to be discussed at your May 15, 2019 hearing. We would respectfully request that this letter be made a part of the hearing record.

CII is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $35 trillion in assets under management.[2]

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[1] Hearings, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, Promoting Economic Growth: A Review of Proposals to Strengthen the Rights and Protections for Workers (May 15, 2019), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403651.
[2] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.

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Human Capital Management (HCM)

CII generally supports H.R. ___, To amend the Securities and Exchange Act of 1934 to require issuers to disclose information about human capital management in annual reports (HCM Bill).[3]

CII believes that institutional and retail investors have a pronounced interest in clear and comparable information about how public companies approach HCM.[4] That interest is supported by the growing body of research that has found that high quality HCM practices correlate with better corporate performance.[5]

Human capital is an increasingly important value driver for companies, including those with securities listed on U.S. exchanges. We would note in this regard that the "ESG" label, in and of itself, may cause confusion to the extent disclosure on human capital as a value driver and source of risk is placed within that category.

CII has a broad tent of members, some more enthusiastic on the language of "ESG" than others, but we are unaware of any segment of our membership that does not consider human capital as important to valuation of most companies, and critical in particular for certain growth sectors.[6]

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[3] H.R. ___, To amend the Securities Exchange Act of 1934 to require issuers to disclose information about human capital management in annual reports, 116th Cong. (2019) (DRAFT), https://financialservices.house.gov/uploadedfiles/bills-116pih-humancapital.pdf [hereinafter HCM Bill].

[4] Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to The Honorable Michael D. Crapo, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate et al. 2 (Apr. 8, 2019), https://www.cii.org/files/April%208%202019%20%20Letter%20to%20Senate%20Banking%20Committee%20KB.docx%20(finalIII).pdf [hereinafter April Letter]; *see* Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure, Investor Advisory Committee 2 (approved Mar. 28, 2019), https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac032819-investor-as-owner-subcommittee-recommendation.pdf ("Institutional and retail investors have a pronounced interest in clear and comparable information about how firms approach HCM"); *see also* Chairman Jay Clayton, Remarks for Telephone Call with SEC Investor Advisory Committee Members (Feb. 6, 2019), https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619 ("for human capital, I believe it is important that the metrics allow for period to period comparability for the company").

[5] *See* Mike Krings, Business Professor Examines Why Firms Don't Use Human Capital Data, UK, Apr. 30, 2019, https://news.ku.edu/2019/04/17/business-prof-examines-why-firms-dont-use-human-capital-data-recommends-steps-improve ("Firms that have low turnover rates, high employee satisfaction and other measures of workforce excellence often have an advantage over their competitors."); Letter from Dr. Anthony Hesketh, Department of Organization, Work & Technology, Lancaster University Management School to Anne Sheehan, Chairman Investor Advisory Committee, U.S. Securities and Exchange Commission 4 (Mar. 21, 2019), https://www.sec.gov/comments/265-28/26528-5180428-183533.pdf (summarizing recent research and including relevant citations suggesting "the depth of human capital disclosure is highly associated with high performance"); Mark Huselid, The Impact of Human Resource Management Practices on Turnover, Productivity, and Corporate Financial Performance, 18 Acad. of Mgmt J. 635 (1995), http://www.markhuselid.com/pdfs/articles/1995_AMJ_HPWS_Paper.pdf (indicating that certain human capital management practices "have an economically and statistically significant impact on . . . long-term measures of corporate financial performance").

[6] We are concerned that some market participants appear to be seeking to limit certain material disclosures by labeling the matters as "ESG." In our view, materiality is materiality. Political efforts to constrain disclosure by slapping the "ESG" label on particular areas and essentially saying these are "no-go" subjects are profoundly misguided. We presume that within the human capital context, those opposed to improving disclosure may be thinking in part of risk areas such as challenges in employee recruitment deriving from discriminatory employment policies or prevalence of sexual harassment. We view these matters as clearly material. To take the latter subject, as

And historically, corporate disclosures on human capital have been limited, in part because of the importance of intangible factors not easily quantified.

We believe that the time has come to seek ways to improve disclosure of both qualitative and quantitative elements of performance in this area.[7] Employee turnover is an example of a measurable, comparable statistic that should be considered as a key disclosure at most or all public companies.[8]

We generally support the recent recommendations of the Investor-as-Owner Subcommittee of the Securities and Exchange Commission (SEC or Commission) Investor Advisory Committee that "as part of its ongoing disclosure review, the Commission . . . undertake a robust examination of the role HCM plays in value creation today and incorporate that analysis into the wide range of tasks the Commission performs on behalf of investors and the US capital markets."[9] As part of this, and without diminishing the need for comparable metrics, we also suggest that the SEC's Division of Corporation Finance consider whether further guidance on company disclosures in Management Discussion and Analysis should be provided to encourage management to do a better job of disclosing to shareholders management's thinking and strategy on human capital development and risks.[10]

HCM Bill

The provisions of the HCM Bill would require all companies that issue an annual report under Section 13 of the Securities Exchange Act of 1934[11] to include specified information about the company's "human capital management policies, practices, and performance."[12] The HCM Bill includes nine specific items recommended in a pending rulemaking petition by the Human Capital Management Coalition,[13] a group that includes a number of CII members.[14] At the time the petition was issued, we commented that "CII believes that the [petition] . . . provides the . . .

CII discussed in a 2018 report, allegations of sexual harassment have had serious repercussions for value at a number of companies, with negative impacts on shareholders. *See* CII, How Corporate Boards Can Combat Sexual Harassment, Recommendations and Resources for Directors and Investors 2 (March 2018), https://www.cii.org/files/publications/misc/03_01_18_corporate_boards_sexual_harassment.pdf ("Allegations of sexual harassment and mishandling those allegations can clearly affect the value of a company.").

[7] April Letter, *supra* note 4, at 3; *see* Mike Krings ("Both the investment and regulation communities should explore the standardization of human capital information").

[8] *See* Mike Krings ("Those who demonstrate . . . low turnover rates . . . would do well to share that information); Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure at 4 (listing "company selected but standardized human capital related key performance indicators (KPIs), such as: [] the stability of the workforce, including voluntary and involuntary turnover").

[9] Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure at 5.

[10] April Letter, *supra* note 4, at 3.

[11] Periodical and Other Reports, 15 U.S. Code § 78m (amended Dec. 4, 2015), *available at* https://www.law.cornell.edu/uscode/text/15/78m.

[12] HCM Bill, *supra* note 3, § 2(s)(2)(A)-(I).

[13] Letter from Meredith Miller, Chief Corporate Governance Officer, UAW Retiree Medical Benefits Trusts to William Hinman, Director, Division of Corporate Finance, Brent J. Fields, Secretary, Securities and Exchange Commission 26 (July 6, 2017), https://www.sec.gov/rules/petitions/2017/petn4-711.pdf.

[14] UAW Retiree Medical Benefits Trusts, Human Capital Management Coalition, Members List, http://www.uawtrust.org/AdminCenter/Library.Files/Media/501/About%20Us/HCMCoalition/hcmmembership2018.pdf.

Commission . . . with a thoughtful resource for further exploration of the need for enhancements to HCM disclosures."[15]

As indicated, we believe there are alternatives to legislation as a means for achieving improvements to public company disclosure of HCM. We, however, note that the HCM Bill provides for SEC rulemaking,[16] which is one possible solution.[17]

As you know, the SEC has a thorough and public due process that provides investors and all market participants the opportunity to provide input to the Commission in response to a proposed rule. In that regard, we would support the following revisions to the HCM Bill that we believe would better ensure that a SEC final rule meets the needs of investors: (1) replace the proposed time period in which the SEC is required to issue "final rules" from "120 days after the date of enactment" to a more reasonable "360 days after the date of enactment;"[18] (2) replace the proposed requirement that the "final rules shall require disclosure" of the nine specific items with a requirement that the Commission "shall consider whether the final rules shall require disclosure" of the nine items;[19] and (3) clarify that the SEC shall consider whether the final rules should include qualitative disclosures that provide issuers the opportunity to explain and comment on required quantitative metrics.

Stock Buybacks

CII generally supports H.R. ___, To require the Securities and Exchange Commission to study whether to amend the rules of the Commission relating to certain stock repurchases, and for other purposes (Buyback Bill).[20]

Public companies are always looking for ways to invest profits to increase their future growth. At some point, they may run out of investment opportunities with enough growth potential to justify an investment. In those cases, companies may decide to use their profits in another way, to buy back shares of the company or to grant dividends.

CII believes that stock buyback decisions are, at their core, capital allocation decisions[21] and making it harder for companies to pursue stock buybacks could force them to sit on cash or

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[15] Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to The Honorable Jay Clayton, Chairman, Securities and Exchange Commission 1 (Oct. 10, 2017), https://www.cii.org/files/issues_and_advocacy/correspondence/2017/10-6-17%20CII%20letter%20to%20SEC%20on%20HCM.pdf.
[16] HCM Bill, *supra* note 3, § 2(s)(2).
[17] Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure at 3 (indicating "rule-making" as possible approach to addressing the issue).
[18] *Id.*
[19] *Id.*
[20] H.R. ___, To require the Securities and Exchange Commission to study whether to amend the rules of the Commission relating to certain stock repurchases, and for other purposes, 116th Cong. (2019) (DRAFT), https://financialservices.house.gov/uploadedfiles/bills-116pih-buybacks.pdf [hereinafter Buyback Bill].
[21] Council of Institutional Investors, Corporate Governance Policies § 5.9b Stock Repurchase Programs (updated Oct. 28, 2018), https://www.cii.org/files/10_24_18_corp_gov_policies.pdf ("Stock buyback decisions are a capital allocation decision").

waste it on projects with a low potential for success.[22] This may not be the wisest use of a company's profits, as it can hurt growth and erode investor confidence.

Moreover, the money spent on buybacks does not evaporate; it is often invested by shareowners in other companies that need capital more than the company executing the buyback. That reinvestment in a higher use creates a benefit that inures to investors and to society more broadly.[23]

CII does not believe that all stock buybacks are appropriate.[24] For example, we believe that companies should not repurchase their shares to boost the stock in the short term—especially if CEO pay is linked to earnings per share or measures of capital efficiency, such as return on equity or return on assets, which are also are lifted when equity is reduced.[25] That is why we advocate for strong corporate governance practices at public companies "guiding how the decisions about stock buybacks . . . are made, to ensure they are made with the long-term interests in mind."[26]

More specifically, CII believes the board of directors should discuss in the company's proxy statement its review and approval process for share repurchase programs with creating long-term value.[27] We also believe management should disclose how stock buybacks affect performance metrics, perhaps in a table showing how the company would have performed absent a change in the number of shares outstanding.[28]

Buyback Bill

The provisions of the Buyback Bill would require the SEC to conduct a study of whether Rule 10b-18, the "safe harbor" share buyback rule,[29] should be amended in a number of ways, including:

- limits on the ability of a company "to announce or implement a stock repurchase plan at [the company] does not intend to fulfill;"[30]

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[22] Joshua Bolton & Ken Bertsch, Opinion, Restricting Stock Buybacks Will Hurt the Economy, N.Y. Times, Mar. 4, 2019, https://www.nytimes.com/2019/03/04/opinion/sanders-stock-buybacks.html ("Making it harder for companies to do [stock buybacks] . . . could force them to sit on cash or waste it on projects with a low potential for success").
[23] Commissioner Hester M. Peirce, Speech, Festivus, Fortnite, and Focus: Remarks before the Council of Institutional Investors Spring Conference (Mar. 5, 2019), https://www.sec.gov/news/speech/speech-peirce-030519.
[24] Council of Institutional Investors, CII Statement on Share Buybacks (Feb. 5, 2019), https://www.cii.org/feb5sharebuybacks ("Some buybacks are not appropriate"); *see* Council of Institutional Investors, Corporate Governance Policies § 5.9b Stock Repurchase Programs ("Stock buyback decisions . . . should not be driven solely for the purpose of minimizing dilution from equity-based compensation plans.").
[25] Council of Institutional Investors, CII Statement on Share Buybacks.
[26] Joshua Bolton & Ken Bertsch.
[27] Council of Institutional Investors, CII Statement on Share Buybacks; *see* Council of Institutional Investors, Corporate Governance Policies § 5.9b Stock Repurchase Programs ("The compensation committee should provide information about stock repurchase programs and the extent to which such programs are used to minimize the dilution of equity-based compensation plans.").
[28] Council of Institutional Investors, CII Statement on Share Buybacks.
[29] Purchase of Certain Equity Securities by the Issuer and Others, 17 C.F.R. § 240.10b-18 (amended June 29, 2005), *available at* https://www.law.cornell.edu/cfr/text/17/240.10b-18.
[30] Buyback Bill, *supra* note 20, § 2(b)(1)(A).

- limits on the ability of a company to announce a new buyback plan if during the prior 12 months the company has not fulfilled a prior buyback plan;[31] and
- disclosure at the time of announcement of the minimum number or dollar amount of shares to be repurchased and the time frame; [32] "timely" disclosures as to each buyback;[33] set a period of time after an announcement within which a director or officer may not sell stock or exercise an option;[34] and an accounting of any significant changes in the period after Rule 10b-18 and prior to adoption in terms of how companies, officers and directors use stock buyback plans.[35]

The Buyback Bill would also require the SEC to report the results of its study to Congress and, within one-year of such report, to amend its rules to address the results of the report.[36]

CII understands and appreciates many of the concerns that have been raised about stock buybacks and Rule 10b-18.[37] We, however, believe the scope of the study contained in the Buyback Bill should not be limited to a Rule 10b-18 framework.

In our view, the provisions of the Buyback Bill should be broadened to include a more comprehensive study how the SEC might improve public company management *and* board disclosures of stock buybacks to better meet the information needs of investors. For example, the study might include what the SEC has learned and potential improvements to stock buyback disclosures in response to its 2016 Concept Release on "Business and Financial Disclosure Required by Regulation S-K" (2016 Release).[38]

The 2016 Release sought input on a number of questions regarding frequency and granularity of the tabular disclosures of equity purchases required by Item 703 of Regulation S-K.[39] One question in particular that we believe should be given further consideration is whether the SEC should require Form 8-K disclosure of stock buybacks that exceed a certain threshold.[40]

[31] *See id.* § 2(b)(1)(B).
[32] *See id.* § 2(b)(1)(C)(i).
[33] *See id.* § 2(b)(1)(D).
[34] *See id.* § 2(b)(1)(E).
[35] *See id.* § 2(b)(1)(F).
[36] *See id.* § 2(c)-(d).
[37] *See, e.g.*, Commissioner Robert J. Jackson Jr., Speech, Stock Buybacks and Corporate Cashouts (June 11, 2018), https://www.sec.gov/news/speech/speech-jackson-061118 (discussing the history of Rule 10b-18 and explaining why the "rules should be updated.").
[38] Business and Financial Disclosure Required by Regulation S-K, Securities Act Release 10,064, Exchange Act Release 77,599 (concept release Apr. 13, 2016), https://www.sec.gov/rules/concept/2016/33-10064.pdf.
[39] *Id.* at 193-94.
[40] *Id.* at 194 ("For example, should we require Form 8-K disclosure only of repurchases that exceed a certain threshold, similar to Item 3.02 of Form 8-K, which requires registrants to disclose sales of equity securities that constitute more than one percent of the shares outstanding of the class of equity securities?"); *cf.* Jesse M. Fried, Insider Trading Via The Corporation, 162 U. Pa. L. Rev. 801, 839 (2014), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=7689&context=penn_law_review (concluding that "[p]ublicly held U.S. firms trading their own shares [should, like insiders, be required to] . . . report the specific details of each trade within two business days").

Improvements in the requirements of Item 703 of Regulation S-K and Form 8-K, perhaps combined with better disclosure about public company boards' review and approval processes for stock buyback programs, could assist investors in better understanding the relationship between stock buybacks, executive compensation, and capital allocation decisions.

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If we can answer any questions or provide additional information that would be helpful to you or the Subcommittee, please do not hesitate to contact me at 202.822.0800 or jeff@cii.org.

Sincerely,

Jeffrey P. Mahoney
General Counsel

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10 May 2019

Maxine Waters
Chairman
House Committee on Financial Services
O'Neill House Office Building
Washington, DC 20024

Dear Chairman

Ref. Bill to amend the Securities Exchange Act of 1934 to require issuers to disclose information about human capital management in annual reports.

I have been asked to write to the House Committee on Financial Services to highlight the relevance of my work to your ongoing discussions regarding policy relating to firms' disclosures on human capital. I am excited by the contents of the Bill and offer myself and my work as a resource to the House and its members in their ongoing work and future discussions. In short, I view the contents of the Bill before Congress offering the United States of America with the chance to lead the world in human capital disclosure practice.

By way of introduction, I am a UK-based tenured academic at Lancaster University Management School with a deep and long-standing interest in the relationship between human capital management and organizational performance. My thesis is a straightforward one. The way we value our relationships with organizations and the products they create is changing, with concomitant and material changes for the underlying financial value of organizations. Human capital and its management are becoming increasingly material to these changes. The Bill clearly speaks to these changes especially in the terms of global citizens who seek a closer and more transparent relationship with the firms for whom they work and whose products they buy.

Below, I outline how material this contribution appears to be, highlighting a new and robust evidence base underpinning the veracity of the recent call made by the *Embankment Project for Inclusive Capitalism* (EPIC) for deeper and wider forms of disclosure pertaining to human capital management.[1] After a short introduction to my work, I present the key findings from my research for EPIC and then discuss the implications of these results in the context of Bill, and, more specifically, in relation to the Securities and Exchange Commission's recent deliberations over human capital disclosure through the SEC's Investor Advisory Committee.[2] Members of Congress short on time might like to turn directly to Section 5.3 below and use the attached presentation deck to obtain the primary points being made below. I should stress here that the opinions expressed in what follows represents my own view and not necessarily those of EPIC participants.

1. The reason for my contacting you

The financial materiality of human capital to firm valuation has evaded the accounting industry's grasp for half a millennium. Stretching back over the last decade, the aim of my research has been to enable global corporations and their wider stakeholders (e.g. investors, employees, suppliers and wider society) to better understand how they manage, measure and report on the value creation of their people.[3]

To date, I have worked directly with senior executives on human capital-related projects in over 100 major corporates (e.g., Aetna, Accenture, IBM, Microsoft, Johnson & Johnson, Unilever, Xerox); major financial regulators (e.g. the Financial Reporting Council and IASB in the UK); "Big Four" audit firms (Deloitte and EY), and, more recently, executives of leading asset owners and managers (e.g., Barings, Blackrock, Fidelity, Investec, Schroders, Vanguard). My recent research has explored the financial materiality of human capital disclosure practices which is of growing importance to the investment community and other stakeholders.

2. Introducing my research for EPIC

Following the positive reception to my work on human capital for the UK government, accounting, management and human resources bodies in 2014,[4] I was approached by the Big Four accounting firm, EY, with a view to collaboratively developing a new evaluation and auditing instrument based on my *Valuing your Talent* Framework (VyT) and my work developing an equation for *the return on invested talent* (ROIT).[5] During this initial work, discussion turned to unpacking the transformation of value more widely with my participation in the *Embankment Project for Inclusive Capitalism* (EPIC).[6]

EPIC was a joint initiative between corporates, asset managers, investors and citizens, EY and over 30 global business leaders to establish metrics that measure long-term value creation for all stakeholders. With the collective power and diversity of the entire investment chain, representing over $30 trillion of assets under management and almost 2 million employees around the world, the original and continuing research has played a central role in contributing to the creation of a unique initiative to measure the multi-dimensions of long-term value that businesses create. I led the empirical research on human capital disclosure for EPIC, culminating in the endorsement of the VyT indicators and Return on Invested Talent (ROIT) equation by participating firms.[7]

These indicators link directly to the information about human capital management policies, practices, and performance outlined in the Bill to amend the Securities and Exchange Act 1934. I shall address each of the items listed in the Bill below after, first, presenting the case for the materiality of human capital disclosure established by EPIC.

3. The EPIC research approach

The research sought to establish the human capital disclosure (HCD) practices of firms in the U.S. S&P 500, UK FTSE 100 and Fortune 100. Specifically, we sought to capture data pertaining to three challenges relating to HCD:

1. *How wide?* The *number* of firms engaging in HCD.
2. *How deep?* Different *types* of human capital-related factors disclosed by firms.
3. *How material?* The *relationship* between HCD and firm performance.

The evidence-base for our analysis comprised two parts:

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3.1 Quantitative data capture and analysis:

a. Deep dive analysis of the financial statements of 700 firms to extract financial fundamentals and to establish reporting of human capital items for the period 2012-17.
b. In the U.S., analysis of the (then) 350 published S&P 500 2018 AGM Proxy Statements to extract employee-related data.
c. Annual reports, CSR reports and other investor relations-related media were also consulted across 300 firms (the top 100 firms in the S&P 500, entire FTSE 100 and the top 100 firms in the Fortune 1000) for quantitative and narrative data.
d. In total, over 2,000 investor relations-related documents released by firms were consulted and codified by the project team.

3.2 Narrative data capture and analysis to establish:

a. The balance between quantum and narrative data points in HCD.
b. The balance between strategic and operational narrative descriptions for human capital-related interventions.
c. The balance between material (quantum) and discursive (narrative) causal argumentation of the relevance of human capital disclosures.

Using a *human capital disclosure index* (HCDI) that I developed, EPIC was able to explore and model the relationship between human capital disclosures and firm performance. With the HCDI on one side of the equation, and the ROIT metric on the other, our analysis enabled us to explore with *robust quantum data points* the association between the financial returns obtained by firms and their human capital disclosure practices.

The HCDI was calculated by focusing on data relating to five indicators originally established and defined by the *Valuing your Talent* project and endorsed by EPIC participants (Table 1):

Table 1: The Valuing your Talent Core Human Capital Indicators

Disclosed Item	*Data examples*
Human capital costs	Salaries, wages, bonuses and pension benefits of *all* employees
Turnover	Voluntary/involuntary leavers and incoming employee data points
Training and development	Total training days, type and costs
Workforce composition	Diversity &inclusivity (D&I), skills and other related data points
Engagement and culture	Surveys exploring employees' attitudes to work and their firms, e.g., purpose, wellbeing and empowerment

I have discussed the rationale for the choice of these variables at length elsewhere.[8] All of the data points outlined above meet the criteria of comparability, verifiability, timeliness and understandability advocated by international accounting standards.[9] They also now benefit from clear definitions offered by the recent publication by *Guidelines for Human Capital Reporting for Internal and External Stakeholders* (ISO 30414:2018).[10] Moreover, each of the variables has the advantage of representing internal data points already disclosed by a substantial number of firms.

In line with *International Accounting Standard IAS 19*, it has been compulsory for firms in the European Union (EU) since 1998 to report their *total* human capital costs in relation to salaries, bonuses and pension benefits. Firms in the U.S. are not currently legally mandated to report this data, resulting in just 15 per cent of S&P 500 firms electing to do so (see Slides 9 & 10 in the attached deck). Discussion with experienced auditors in leading accounting firms reveals any incremental costs incurred by firms

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in meeting these new reporting variables to be minimal.[11] Our modelling reveals the potential future financial benefits released as a consequence of firms' enhanced transparency and subsequently more effective management of the human capital processes will exceed the cost by many times (see 4.8 below).

Largely because of this and other recent legislation and developments (e.g., the recent obligation for UK firms to report gender pay gap data, and now the recent ISO standard on Human Capital Reporting), human capital disclosure practices are more mature in the UK and EU in comparison to the U.S. For example, a report published in March 2019 by Deutsche Bank research analysts observed, 'given many companies are thinking about implementing [human capital variables] as soon as possible, it will soon be possible to incorporate human capital issues into fair value analysis.'[12] This brings us nicely to the data obtained by the EPIC *Human Capital Working Group*.

4. EPIC research results

At the very least, EPIC's findings suggest a rejection of the null hypothesis that human capital disclosure has no effect on firm performance. In fact, our data suggest the depth of human capital disclosure is highly associated with high performance.

More specifically, our analysis established:

4.1 **Human capital cost disclosers perform better.** Those S&P 500 firms disclosing their total human capital costs are disproportionately represented in the highest performing firms (see Slide 12), whether measured in terms of *risk-adjusted returns* or *means excess returns*, both asset management industry standards (Slide 13).

4.2 **The deeper the disclosure, the greater the economic returns secured from talent.** Using the HCDI developed by myself and endorsed by EPIC participants, analysis has established how firm financial performance increases in step with human capital reporting intensity (see Slides 14-16).

4.3 **Disclosers obtain a higher return on investment from talent (ROIT).** Similar to the concept of return on invested capital (ROIC), the ROIT calculation enables firms to establish the returns generated from their investment in human capital. The ROIT for those firms in the upper quartile of human capital reporting (£3.01 for every £1 invested) were nearly three times those with those with the lowest quartile of human capital disclosure (£1.17).

4.4 **U.S. disclosers also typically achieve out-performance.** Even in the U.S., where human capital disclosure is less extensive, top-quartile human capital reporting firms ($2.09 for every $1 invested) on average outperform the returns secured from talent by those in the bottom quartile of human capital reporting ($1.87).

4.5 **Human capital cost disclosers focus on value creation over the long term.** U.S. firms who disclose in full their human capital costs on average secure higher levels of operating margin and retain higher levels of earnings to reinvest in the future returns of their businesses (Slide 17). Non-human capital cost disclosers secure greater returns on equity but leverage significantly higher levels of debt.

4.6 **More developed human capital reporters let their numbers do the talking.** Evaluating recent developments in corporate narrative reporting, analysis also revealed how those firms with greater levels of human capital disclosure in *quantum* form use three times *less* words in their supporting

narratives than other firms (Slides 19 and 20).

4.7 **More than 4/5 firms in the UK's FTSE 100 spend more on their human capital salaries and benefits than their formally stated audit level of materiality.** Half FTSE 100 firms exceed this materiality level by greater than a factor of 20, underlying the fiduciary requirements of greater transparency relating to the disclosure of human capital practices (Slide 21). Our research established nearly one in three firms (30%) in the S&P 500 exercised their right not to include all of their global workforce, omitting 5 per cent or more from 2018 proxy statement payment ratio relating to the median employee's salary. This raises potentially serious as well as financially material issues over the integrity of firms' income statements.

4.8 **The possible future benefits from greater human capital disclosure far outweigh the costs.** Our modelling reveals firms' *total* human capital disclosure-related costs are at levels significantly below the anticipated economic returns we have conservatively estimated to be brought about by greater understanding of the business through more effective human capital management as a result of disclosure (see 4.3 above). A tiny increase in operating performance (several basis points) is required to cover any additional costs incurred though human capital disclosure. Significantly, the vast majority of firms already undertake significant audits of their payroll systems thereby reducing the need to attract any additional costs for reporting purposes.

We pause here to insert a caveat. We are not implying the disclosure of data pertaining to human capital management is a conventional causal or 'leading indicator' of out-performance. However, our findings are interesting. Of the 75 firms in the S&P 500 consistently disclosing their human capital costs, nearly two-thirds (60%) can be found in the top-performing 20% of firms. This trend has been consistent over the duration of the timescale under analysis (2012-17). Conversely, those disclosing their human capital costs are disproportionately under-represented in the bottom-performing 20% of firms in the S&P 500. Something appears to be going on, which underlines the need for further and more uniform compulsory disclosure. The executives involved in the human capital working group favoured the interpretation that well-run businesses who were confident enough to articulate their metrics around human capital in quantum form might be better placed to make financially accretive material interventions. At national level, even the slightest performance-gain from a more transparent approach to disclosing and managing human capital resources might be substantial for the U.S. economy.

5. Possible implications of EPIC for Congress to consider

In this section I address the specific issues relating to human capital disclosure uncovered by EPIC and raised at the recent SEC Investor Advisory Committee. I then deal specifically with each of the nine items of human capital disclosure proposed by the Bill. There are several sources of information pertaining to SEC meeting in March[13] but my focus here is on Chairman Clayton's remarks during the telephone call with SEC Investor Advisory Committee Members on February 6, 2019.[14] This discussion has important ramifications for the reporting of human capital items listed in the Bill. We have grouped Chairman Clayton's remarks into two overarching sections. We deal with each in turn.

5.1. Framework for analysing disclosure rules

Chairman Clayton raised five specific issues in relation to the framework for analysing disclosures. Our research for EPIC has ramifications for each of these topics. We unpack these below.

1. Materiality: Chairman Clayton evokes Justice Marshall's observation and how, 'disclosure rules and guidance, and our issuers, should focus on the material information that a reasonable investor needs to

make informed investment and voting decisions.'[15] Our findings are of interest here on four counts:

a) Our research has revealed how more than 4/5 firms in the UK's FTSE 100 spend more on their human capital than their formally stated and audited level of materiality (slide 20). Half FTSE 100 firms exceed this level of materiality by more than a factor of 20, underlining the significance of human capital in meeting directors' fiduciary requirements of disclosure (see Section 4(6) above).
b) In the U.S. reporting context, human capital is a currently neglected factor of economic production requires a higher level of granularity afforded to it than currently offered by the cost of goods sold (COGS) or the general sales and administration (GS&A) on current income statements.
c) We believe the five core human capital indicators presented above and the ROIT metric offer the investment and wider stakeholder communities the opportunity to calculate from robust financial fundamentals the "metabolic rate" at which people perform in different firms. This enables information pertaining to material questions to be answered including: what is the role of our human capital in delivering our strategy? How are we performing? How do we know? Is the performance of our human capital improving or declining? Where is most value located or at most risk in our human capital base? Where might we invest for greatest economic returns?
d) Finally, EPIC represented a direct response to the evolution in wider society's changing conception(s) of value.[16] The investment community is demanding more information in relation to employees' experience of working for an organization. New comparative market places are evolving raising new challenges in shaping the new modalities through which the different elements of value flow.[17] These new modalities are bringing with them different ways of understanding, articulating and measuring sustainable value, be they *economies of experience* (employee value propositions), *reciprocity* (who you do business with and how) or *materiality* (the evidence base for claimed performance provided).[18] Such new economies materially shape wider aspects of human capital value ranging from potential employee and wider consumer decision making with clear ramifications for the brand value of organizations.
e) To this we can add the endorsement of the IAC Committee's recommendation that human capital disclosure move through the SEC's formal review process with a view to exploring robust methods of reporting by firms.

2. *Comparability*: EPIC participants debated at length the disclosure requirements relating to human capital. The five core indicators outlined above (see Table 1) represent the agreed indicative human capital disclosures required from firms and endorsed by EPIC chief executives.[19] Whilst a number of firms are already reporting these indicators in the UK and EU, the U.S. trails behind, especially in the disclosure of human capital costs (slides 9-10). Each of the five core indicators highlighted above represent, 'metrics that provide for reasonable market-wide comparability.'[20] There may be a requirement here for GAAP to clarify the role of human capital costs and benefits in contributing to, or even representing the resource or *architectures of firm value* under construction.[21]

3. *Flexibility*: EPIC participants were keen to accommodate variations between firms and sectors in relation to human capital disclosures but recognised the need for a central core of metrics to ensure comparability. A flexible approach could also accommodate over time the development of second and third waves of voluntary disclosures as firms respond to changes in markets and industry for the underlying drivers beneath core human capital disclosure requirements. Firms also have the flexibility to provide supporting narratives to elucidate on the stories behind the core quantum disclosures in their human capital management strategies. This would enable investors to, 'be better served by understanding the lens through which each company looks at their human capital.'[22]

4. *Efficiency*: Our analysis established how those firms providing the deepest level of core quantum human capital disclosures required less volume in their narrative reporting to articulate progress: a classic case of saying materially more with less (Slide 10). A possible corollary of adopting the five core human capital disclosure items might be to reduce costs via savings in time and reduced reporting space currently plaguing firms' annual reporting. Significantly, there is growing evidence that those firms who provide deeper levels of human capital disclosure also enjoy material benefits in securing lower costs of equity capital.[23] Additional research by financial analysts has established how, 'improving disclosures makes the capital allocation process more efficient and reduces the average cost of capital.'[24] By introducing a few core metrics, significant value may be released in line with Chairman Clayton's request for the, 'most effective [rule] with the least cost.'[25] A significant factor lies in the added cost associated with this additional reporting is marginal as many firms are either already informally reporting these data or have the information to hand in already established budget lines and management accounting practices.

5. *Responsibility (or liability)*: Chairman Clayton highlights how, 'rules have little long-term value if they cannot be effectively monitored and enforced.'[26] By focusing on the EPIC core set of human capital disclosures which represent robust and quantum data points, the SEC can steer a clear path forward for uniform disclosure in this materially important space, thereby further enabling the protection of investors through maintaining fair, orderly, and efficient markets and facilitating capital formation.

5.2 Moving human capital from a cost to value driver

The SEC's chairman, Jay Clayton observes how, 'today, human capital and intellectual property often represent an essential resource and driver of performance for many companies,' and how this represents, 'a shift from human capital being viewed, at least from an income statement perspective, as a cost.'[27] This observation brings into sharp focus how in a knowledge-based and service-oriented economy human capital does not represent the *costs* of the gasoline running through the engine, which is to be sourced as efficiently as possible. Rather, human capital represents the value-driving engine - or human *resource* - of the firm.[28]

Significantly, recent changes to the IFRS's *Conceptual Framework for Financial Reporting* have brought to a conclusion the revised definition of an asset, 'as a present economic resource controlled by the entity as a result of past events.'[29] For example, the newly separate definition of an economic resource as, 'a right that has the *potential* to produce economic benefits,' may not only enable developments in GAAP to, 'clarify that an asset is the economic resource, not the ultimate inflow of economic benefits,'[30] but, building on a previous IFRS discussion document[31],may even allow us to explicitly highlight how the workforce itself can constitute an economic resource, opening up the very real possibility of future developments in GAAP relating to the associated costs and benefits of *human capital resources*.

With the latest definition of an asset now deleting the need for the *expected* flow of economic resources, 'to be certain, or even likely, that economic benefits will arise,' the requirement for further transparency and granularity in human capital resource-related costs and benefits is now material to our understanding of how a, 'low probability of economic benefits,' arising from a firm's human capital management, 'might affect recognition decisions and the measurement of the asset.'[32]

5.3 The implications of EPIC for the Bill to disclose information on human capital management

A comparison between the metrics advocated by EPIC participants and those listed in the Bill is provided in the attached deck (see Slide 8). I will deal with each in turn in the order of magnitude I

believe each of the human capital disclosure items to represent.

1) *Human capital costs - Workforce compensation (I):* This variable was viewed by EPIC participants as the foundation stone for comparative and analytical purposes by different stakeholders. There are different issues to consider:
   a) The practice in the UK and EU of reporting total costs broken down across salaries, bonuses and benefits and pensions of employees is both well-established and proportionate. This provides a standard against which this disclosure requirement can be reported.
   b) EPIC research revealed just 13% of the top 100 firms in the S&P index currently report their total workforce costs data.
   c) Establishing the standardization of these data points will over time enable markets to establish material changes in workforce compensation and returns, highlighting the centrality of workforce compensation to other items listed in the Bill (e.g. workforce productivity).
   d) The different data points relating to workforce compensation included in the Bill may evolve over time as the baseline data points suggested in a) lead to requests for further information from parties with material interests.
   e) How fair can fair value be without factoring in the costs of one of the major factors of production? The old adage that what gets measured gets managed would appear to hold true insofar as our data suggests that firms disproportionately disclosing more human capital items in the U.S. as well as in Europe in the Rest of the World typically out-perform those who disclose less.
   f) The claim that firms may place at risk their competitive advantage is a red herring when viewed in the context of compulsory reporting of human capital costs in the UK and Europe. Profit per employee or revenues per employee are useful benchmarks for comparative purposes but hardly represent invasive disclosure or the politicisation of workforce compensation.
   g) The level of detail afforded to the justification for executive remuneration is wholly disproportionate to the opacity of information the majority of U.S. firms currently disclose relating to their total workforce costs. This anomaly requires rectification.

2) *Turnover – Workforce Stability (B):* This variable was seen by many EPIC participants as a critical data point in understanding the contribution of human capital to firm performance.
   a) Turnover represents a quantum data point which can easily be fed into additional modelling by analysts.
   b) A number of established quantum variables are already habitually reported by firms. These data points can reveal not just the turnover of staff, but can reveal underlying patterns in workforce stability (e.g. regrets versus non-regrets) and the workforce levels at which this churn takes place (e.g. management regrets versus non-management regrets), enabling at the very least the beginning of a conversation between different stakeholders to establish the stability of a firm's workforce.
   c) EPIC research revealed 34% of the top 100 firms in the S&P index currently report workforce stability data.
   d) The incorporation of workforce stability data points could, for example, enable stakeholders to utilize portfolio choice theory to ascertain the extent to which volatility in employee churn is material to a firm's performance relative to others. Over time, such an index could become an important benchmark informing labour market decisions by wider stakeholders (employees, suppliers, etc) as well as capital markets.
3) *Workforce composition – Workforce demographic information (A), Workforce composition (C), Workforce skills and capabilities (D):* A long tradition of research exploring the positive impact between certain workforce demographics and so-called high-performance work systems exists.[33] There is considerable overlap between what EPIC described as workforce composition and different human

capital disclosures requested by the Bill. The higher levels of granularity required by the Bill could encourage further transparency and clarity of disclosures over time.

a) Workforce demographic information has been discussed and defined elsewhere.[34] At issue here are the definitions of different employees (full or part time) and their relationship to the firm.
b) EPIC research revealed 75% of the top 100 firms in the S&P index currently report workforce composition-related data.
c) Recent developments in the UK relating to compulsory disclosures over gender pay for firms with more than 250 employees have raised the issue of diversity in a number of ways, revealing reporting discrepancies by firms which have subsequently been rectified. Greater transparency of this issue has raised the profile of the gender pay gap in firms and led to tighter controls of and improvement in the quality of disclosures and human capital management practices in this space.[35]
d) Workforce skills and capabilities represent a more challenging reporting item. The advantage of greater understanding of the type and frequency of different capabilities enables firms and wider stakeholders to better understand the capacity of human capital in determining the value at risk across a firm's asset base. Implementation of the Bill would enable stakeholders to be in a better position to evaluate and manage the *human capital value at risk* in firms and monitor and mitigate such risks accordingly.

4) *Training and development – Workforce skills and capabilities (D):* This variable represents an important insight into the replenishment of the workforce and has suffered in disclosure terms because of its close association, and often conflation, with research and development costs which has its own reporting item in GAAP. Again, an evidence base does underpin the veracity of this variable in explaining firm performance.[36]
   a) Variables here can include total spend on training and development, number of employees trained, and the total number of FTE days engaged in training.
   b) EPIC research revealed 38% of the top 100 firms in the S&P index currently report their training and development data.
   c) Employees remain significantly interested in development opportunities. Yet prospective employees can yield little information about training opportunities provided by firms.
   d) Investors and other stakeholders also take a significant interest with material consequences in training and development when capital expenditure can be clearly related to human capital and overarching firm strategies.[37]
   e) Training and development could represent an important variable in the possible future calculation of the human capital asset in relation to the capitalisation of associated costs.

5) *Engagement, wellbeing and culture – Workforce culture and empowerment (E) and Workforce health and safety (F).* This variable was a significant driver in EPIC's human capital research. It was viewed as a barometer gauging the relationship between a firm and its people.
   a) Variables here are often based on staff surveys managed by external providers who enable firms to benchmark their employees' attitudes to the firm and their work with comparators. Variables include enjoyment at work, whether an employee would recommend their firm to a friend and the perceived quality of leadership, purpose and a number of other factors.
   b) EPIC research revealed just 20% of the top 100 firms in the S&P index currently report their workforce culture and empowerment (e.g. employee engagement) data.
   c) The relationship between employee sentiment and firm performance is difficult to analytically establish, although recent research on workforce culture and equity prices has established a performance gain for those firms whose employees feel positive about the culture in which they work.[38]

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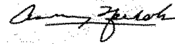
6) *Human rights commitments and their implementation (G):* This variable was effectively endorsed by EPIC participants, albeit indirectly, through the powerful force of purpose which was identified as a key driver of value.
   a) There is an evolving literature and evidence base advocating dual purpose firms serving the interests of shareholders and wider society and marrying these two concepts under the aegis of purpose.[39]
   b) More recent research has highlighted how greater transparency can create new differentiators by capital markets in terms of new *economies of reciprocity* (where firms are judged not just by their own practices but in terms of the practices of the companies they use as main suppliers) or *economies of impact* (such as environmental, social and governance [ESG] factors).[40]

In conclusion, the adoption by research analysts in the investment community referred to above, together with the findings from EPIC's human capital working group, clearly indicates portfolio managers are waking up to the materiality of human capital in their fair value calculations and are consequently factoring in data points to their analysis. The CEOs of firms across the entire value chain have endorsed the core human capital disclosure items as a way forward to deepen our understanding of how firms are recognising and leading on the importance of the contribution made by their people. In short, the time for human capital accounting has come. This Bill represents an opportunity for the United States of America to move from the bottom to the top of the human capital disclosure table, ensuring its people are managed in the most transparent and accountable firms in the world.

I wish you all a productive discussion and commend the Bill to the House.

Yours sincerely



Dr Anthony Hesketh

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[1] Coalition for Inclusive Capitalism & EY (2018) *Embankment Project for Inclusive Capitalism (EPIC)* (New York: CIC/EY). I should stress here that the opinions expressed in this note represent my own views and not necessarily those of all EPIC participants.

[2] SEC (2019) Meeting of the Investor Advisory Committee, 28th March, 2019, Retrieved from https://www.sec.gov/rules/other/2018/33-10611.pdf, accessed 10th May 2019; SEC (2019) *Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure*, Retrieved from https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac032819-investor-as-owner-subcommittee-recommendation.pdf, accessed 10th May 2019; Clayton, J. (2019) Remarks for Telephone Call with SEC Investor Advisory Committee Members, February 6th, 2019, Retrieved from https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619#_ftn2., accessed 15/2/19

[3] See Hesketh, A. & Fleetwood, S. (2006) Beyond Measuring the HRM-Organizational Performance Link: Applying Critical Realist Meta-theory, *Organization*, Vol. 13 No. 5, pp. 677-699; Hesketh, A. & Fleetwood, S. (2006) 'HRM-Performance Research: Under-theorised and Lacking Explanatory Power,' *International Journal of Human Resources Management*, 17(12), pp.1979-1995; Fleetwood, S. & Hesketh, A.J. (2006), 'Prediction in Social Science: the case of research on the Human Resource Management-Organisational Performance Link,' *Journal of Critical Realism* Vol. 5, No. 2., pp. 228-250.; Fleetwood, S. & Hesketh, A. (2007) 'Theorising Under-theorisation in Research on the HRM – Performance Link', *Personnel Review* ; Fleetwood, S. & Hesketh, A. (2010) *Explaining the Performance of Human Resources Management* (Cambridge, Cambridge University Press); Hesketh, A. & Hird, M. (2010) The Golden Triangle: How Relationships Between Leaders Can Leverage More Value From People, in P. Sparrow, A. Hesketh, M. Hird, C. Cooper (eds) *Leading HR* (Oxford: Palgrave), pp. 103-135; Hesketh, A. (2014) *Managing the Value of Your Talent: A new framework for*

human capital management (London: CIMA, CMI, CIPD, RSA, UKCES); Hesketh, A. McMinn, H. and Lewis, H. (2014) *What Price Talent? Introducing a new metric to understand the return on investment from talent* (London: Deloitte); Hesketh, A. (2017) Architectures of value: moving leaders beyond big data and analytics. In P. Sparrow & C. Cooper (eds.) *A research agenda for Human Resource Management*. Cheltenham: Edward Elgar; Hesketh, A. (2019) 'The leadership of value. Leading the Leading Indicators of good dividends,' in S. Kempster and T. Maak (eds), *Good Dividends: Responsible Leadership of Business Purpose*: Routledge: New York.

[4] Hesketh, A. (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES)

[5] Hesketh, McMinn and Lewis (2014) *What Price Talent? Introducing a new metric to understand the return on investment from talent* (London: Deloitte)

[6] EPIC/EY (2018) *Embankment Project for Inclusive Capitalism (EPIC)* (New York: CIC/EY, Inside Back Cover

[7] See EPIC (2018), pp. 42-44; EPIC/EY/CEO Statement of Support (2018) *Business leaders unite to advance long term value measures* (New York: CIC EY). The original research citing these metrics was published in Hesketh, A. (2014)) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES)and Hesketh, McMinn and Lewis (2014) *What Price Talent? Introducing a new metric to understand the return on investment from talent* (London: Deloitte)

[8] Hesketh (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES)

[9] For example, see International Accounting Standards Board (IASB) (2018) *The conceptual framework for financial reporting* (London: IASB/IFRS Foundation), Chapter 3.

[10] The International Organization for Standardization (ISO) *Human resource management — Guidelines for human capital reporting for internal and external stakeholders*, Lignes directrices — Bilan du capital humain à l'attention des parties prenantes internes et externs, ICS: 03.100.30. See International Organization for Standardization. (2018, December). "Human resource management – Guidelines for internal and external human capital reporting." Retrieved from: https://www.iso.org/standard/69338.html.

[11] This is based on confidential personal correspondence with major accounting firms. There is considerable variation and complexity between firms in relation to size and industrial sector. The additional metrics we are suggesting are already collected by a number of firms and any incremental cost would be minimal as a percentage of the total audit costs. Indeed, many of the Fortune 1000 firms outside the US are already undertaking this disclosure.

[12] Templeton, L & Allen H. (2019) *Valuing human capital*. Deutsche Bank Research 13 February, 2019, p. 2.

[13] See footnote 2, above.

[14] Clayton (2019) *ibid.*

[15] Clayton (2019) *ibid*

[16] Hesketh, A. (2019)) 'The leadership of value. Leading the Leading Indicators of good dividends,' in S. Kempster and T. Maak (eds), *Good Dividends: Responsible Leadership of Business Purpose*: Routledge: New York.

[17] Almquist, E., Senior, J and Bloch, N. (2016) 'The Elements of Value: Measuring and delivering what consumers really want,' *Harvard Business Review*, September, pp. 47-53

[18] Hesketh (2019)) 'The leadership of value. Leading the Leading Indicators of good dividends,' in S. Kempster and T. Maak (eds), *Good Dividends: Responsible Leadership of Business Purpose*: Routledge: New York

[19] EPIC/EY/CEO Statement of Support (2018) *Business leaders unite to advance long term value measures* (New York: CIC EY).

[20] Clayton (2019) *ibid.*

[21] For example, see Barney, J. (1991) 'Firm Resources and Sustained Competitive Advantage,' *Journal of Management*, Vol 17., No. 1: 99-120; Hesketh (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES); Hesketh, A. (2017) Architectures of value: moving leaders beyond big data and analytics. In P. Sparrow & C. Cooper (eds.) A research agenda for Human Resource Management. Cheltenham: Edward Elgar

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[22] Clayton (2019) *ibid.*
[23] For example, see Boujelbene, M.A. & Affes, H. (2013) 'The impact of intellectual disclosure on cost of equity capital: A case of French firms,' *Journal of Economics, Finance and Administrative Science*, p. 18(34), pp. 45–53.
[24] Source: CFA (2013*) Financial Reporting Disclosures: Investor perspectives on transparency, trust and volume*, Appendix C,, pp.105-107; FASB (2001) *Business Reporting Research Project* (FASB); Sengupta, P (1998) "Corporate Disclosure Quality and the Cost of Debt," *Accounting Review*, vol. 73, no. 4 (October 1998):459; Francis, J.R., Khurana, I.K. and Pereira, R. (2005) "Disclosure Incentives and Effects on Cost of Capital around the World." *Accounting Review*, vol. 80, no. 4 (October 2005):1125; Agnes Cheng, C.S., Collins, D. and He Huang, H. (2006) "Shareholder Rights, Financial Disclosure and the Cost of Equity Capital," *Review of Quantitative Finance and Accounting*, vol. 27, no. 2 (September 2006):175.
[25] Clayton (2019) *ibid.*
[26] Clayton (2019) *ibid.*
[27] Clayton (2019) *ibid.*
[28] See Hesketh (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES) for a discussion.
[29] IFRS (2018) *Conceptual Framework for Financial Reporting: Summary of changes*, March 2018 (London: IASB/IFRS) p.8
[30] IFRS (2018), *op cit.*, emphasis added.
[31] IFRS (2013) *A Review of the Conceptual Framework for Financial Reporting*, Discussion Paper DP/2013/1, para. 3.5, (c), (iv), p. 38.
[32] IFRS (2018), *op cit.*
[33] See Huselid, M. A. (1995). The impact of human resource management practices on turnover, productivity, and corporate financial performance. *Academy of management journal*, *38*(3), 635-672.
Jackson, S. E., Schuler, R. S., & Jiang, K. (2014). An aspirational framework for strategic human resource management. *The Academy of Management Annals*, *8*(1), 1-56; Jiang, K., Lepak, D. P., Hu, J., & Baer, J. C. (2012). How does human resource management influence organizational outcomes? A meta-analytic investigation of mediating mechanisms. Academy of management Journal, 55(6), 1264-1294.
[34] See Hesketh (2014) *Managing the Value of Your Talent: A new framework for human capital management* (London: CIMA, CMI, CIPD, RSA, UKCES) for a discussion.
[35] Ehrenberg, B., Wisniewska, A., and Gordon, S. (2017) 'Cluster of UK companies reports highly improbable gender pay gap,' *The Financial Times*, 7th December, Retrieved from https://www.ft.com/content/ad74ba76-d9cb-11e7-a039-c64b1c09b482?segmentId=080b04f5-af92-ae6f-0513-095d44fb3577, accessed 7th December 2017
[36] Laurie Bassi & Dan McMurrer, (2010) "Human Capital Management Predicts Stock Prices," at 1 (June 2010) (http://mcbassi.com/wp/resources/documents/HCMPredictsStockPrices.pdf)
[37] For example, see Edwardes Jones, J. and Letheren, E. (2019) 'Unilever: Ctrl-Alt-Delete' RBC Capital Markets Equity Research, February 2019
[38] Edmans, A. (2011) "Does the Stock Market Fully Value Intangibles? Employee satisfaction and equity prices" *Journal of Financial Economics*, Vol. 101, 621-640 (2011), (http://faculty.london.edu/aedmans/Rowe.pdf).
[39] See Battilana, et al (2019) 'The Dual purpose playbook: what it takes to do well and good at the same time,' *Harvard Business Review*, March-April 2019, pp. 125-133; Hesketh, A. (2019) 'The leadership of value. Leading the Leading Indicators of good dividends,' in S. Kempster and T. Maak (eds), *Good Dividends: Responsible Leadership of Business Purpose*: Routledge: New York.
[40] See Hesketh, A. (2019) 'The leadership of value. Leading the Leading Indicators of good dividends,' in S. Kempster and T. Maak (eds), *Good Dividends: Responsible Leadership of Business Purpose*: Routledge: New York.

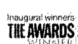
Lancaster University
Management School

A Capital Idea?
The financial case for human capital disclosure by firms

Presentation to accompany slides sent to the the chair, House Committee on Financial Services for consideration in relation to Bill to amend the Securities Exchange Act of 1934 to require issuers to disclose information about human capital management in annual reports, May2019

Anthony Hesketh BSc Econ, PhD
Associate Professor, Lancaster University Management School, UK

TRIPLE-ACCREDITED, WORLD-RANKED



Introducing Embankment Project for Inclusive Capitalism (EPIC)

EPIC's global significance

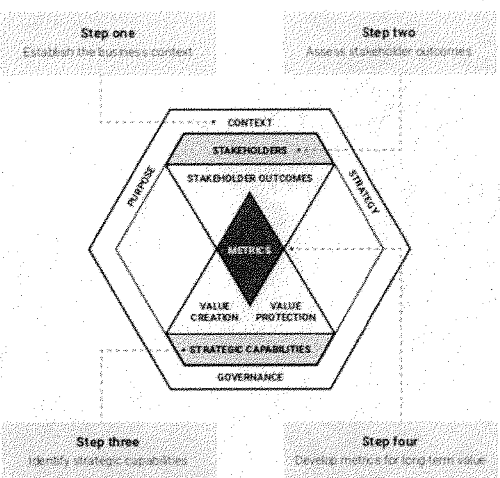
Wider stakeholder/Investment community led …

A four step process to develop metrics for long-term value

Companies can use this approach to better articulate to investors how they create and measure long-term value.

Step one
Establish the business context

Step two
Assess stakeholder outcomes



Step three
Identify strategic capabilities

Step four
Develop metrics for long-term value

Feature: Five criteria for metrics

1. Lead indicators

2. Measuring outcomes and impacts

3. Materiality

4. Comparability

5. Investor verified

Lancaster research findings for EPIC

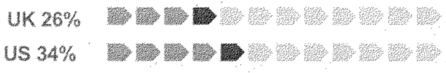
- Consensus on what comprises human capital disclosure (HCD)
  - Endorsement by CEO's of 5 talent-related KPIs:
  - 1) Composition; 2) costs; 3) turnover; 4) training; 5) engagement
- Systematic analysis and unique dataset of *Lancaster HCD Index*
- Case for HCD moved beyond aspirational to *financially* material
  - HCD disclosers disproportionately high performers
  - Linear relationship between *HC Disclosure Index-ROIT* (FTSE 100)
  - The more discursive the HCD, the poorer the performance
- Work continues on establishing *human capital asset* calculation
  - Now, we can add *means excess returns* and *risk-adjusted returns*

Our research findings in a nutshell

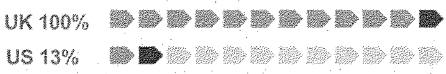
Positive correlation between financial performance and disclosure of HCD data

Regulations drive HCD disclosures

Frequency of human capital reporting - **Turnover**



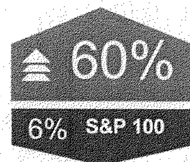
Frequency of human capital reporting – **Employee costs**



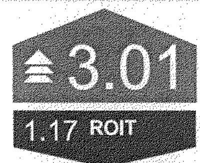
In the US, firms that disclose their Human Capital 'costs' secure higher levels of productivity than non-disclosers

46% difference in ROIT between disclosures and non-disclosures

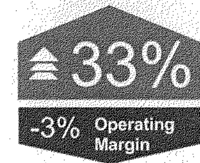
Of the S&P firms that disclose costs, 60 are in the top 100 S&P by EBIT for 2015-17



Firms with higher Human Capital Reporting scores show higher productivity



UK firms in top quartile for reporting get **greater return on investment in talent**



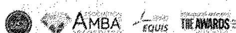
UK firms in top quartile secure **higher operating margins**

Firms who disclose the most human capital data say less in their narratives.

Low human capital disclosers use **3x** more narrative observations than top quartile firms

~60% of firms focus their narrative on operational description

Human Capital Disclosure - How deep and wide?



Comparison between EPIC indicators and the 2019 Bill

EPIC Disclosure Items	2019 Bill Disclosure Items	Examples
Human capital costs	(I) Workforce compensation and incentives	Salaries, wages, bonuses and pension benefits of all employees
Turnover	(B) Workforce stability information	Voluntary/involuntary leavers and incoming employee data points
Workforce Composition	(A) Workforce demographic information (C) Workforce composition (D) Workforce skills and capabilities	Full/part time employee numbers Diversity &inclusivity (D&I), skills, capabilities and other related data points
Training and development	(D) Workforce skills and capabilities	Total training days, type and costs
Engagement, wellbeing and culture	(E) Workforce culture and empowerment (F) Workforce health and safety	Employees' attitudes to work e.g., purpose, wellbeing and empowerment Frequency, severity, and lost-time due to injuries, illness, and fatalities
N/A	(G) Human rights commitments and their implementation	Principles used to evaluate risk, constituency consultation processes, and supplier due diligence

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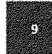
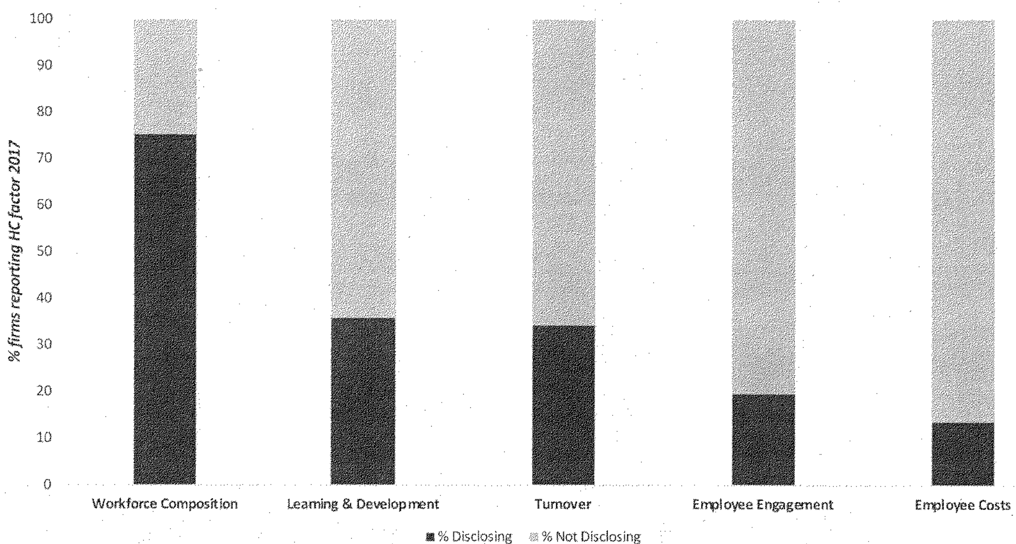
US: HC factor reporting still in nascent form

N= 100 

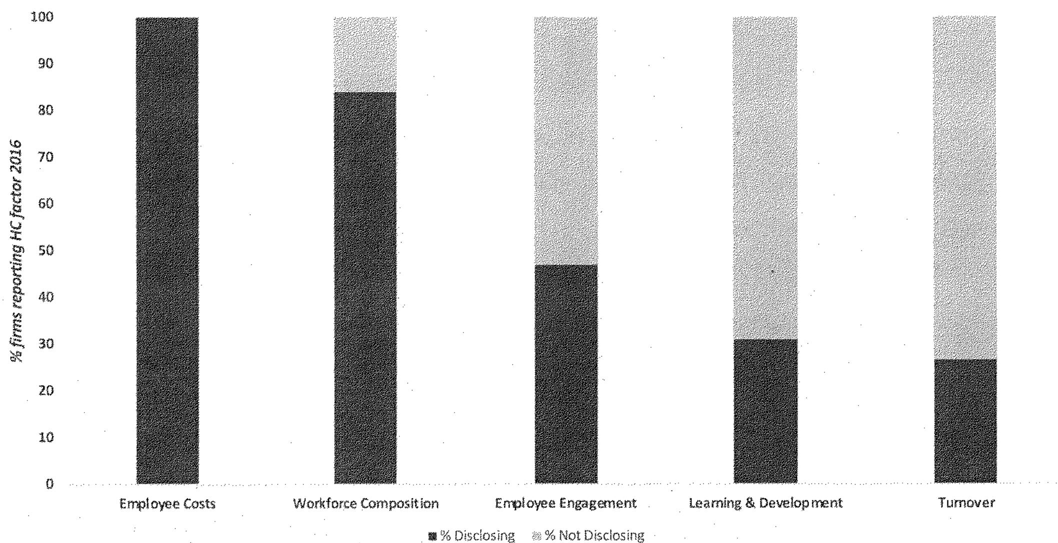
Source: S&P 500, Analysis by Lancaster University Management School for EPIC



Only 75 firms in the S&P 500 formally report their human capital related costs (salaries, bonuses and benefits). Although most firms in the S&P Top 100 by Revenue disclose data relating to workforce composition (e.g., D&I data), the overwhelming majority fail to report other key human capital factors. Compared to the UK and EU, the most striking of these is total workforce cost with less than 1:8 in the US, compared to 100% in the EU and UK. There are regulatory reasons for this.

UK: HC factor reporting more mature

N=100



Due to regulation in the UK and EU, all firms report total costs relating to employee salaries and benefits, and, from April 2017, data relating to gender pay and workforce composition will also be compulsory. Significantly more firms report employee sentiment data (e.g. engagement), although the UK lags behind the US on employee turnover.

Source: FTSE100 & Firm publications. Analysis by Lancaster University Management School for EPIC

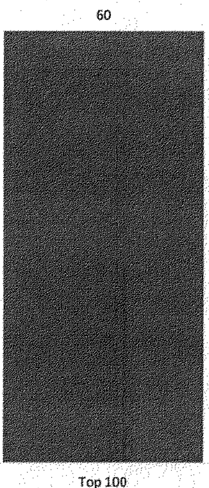
Human Capital Deployment

-

The Performance Case

US: HC cost disclosers disproportionately higher performers N=495

Source: S&P 500, Analysis by Lancaster University Management School for EPIC



Those firms disclosing their HC costs in the S&P 500 firms are disproportionately and consistently found in the top 100 firms 2015-17 measured by EBIT margin, and under-represented in the bottom 100 EBIT-performing firms.

Disclosers outperform non-disclosers

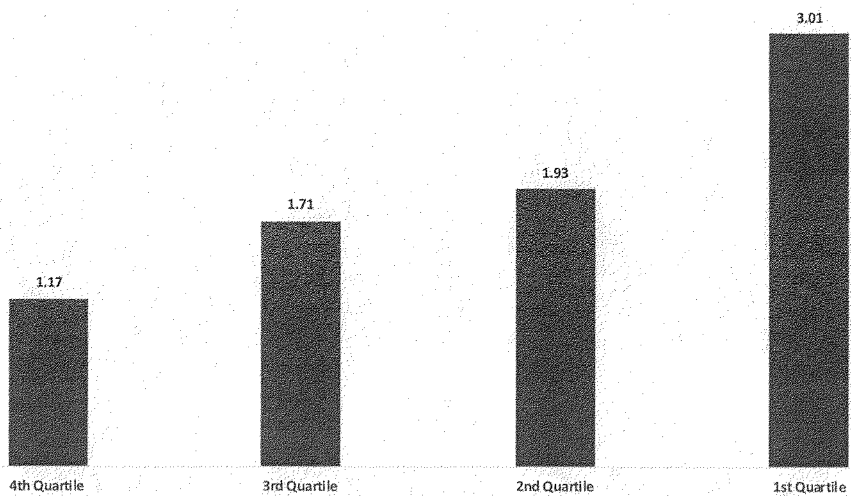
Yearly Average Data			
2017	Mean Excess Returns (%)	Sharpe Ratio	Volatility (Std. Dev.)
Disclosure Group	0.79	0.21	5.42
Non-Disclosure Group	0.73	0.17	0.73
2016			
Disclosure Group	1.25	0.64	7.77
Non-Disclosure Group	1.11	0.16	7.19
2015			
Disclosure Group	-0.028	0.005	6.27
Non-Disclosure Group	0.175	0.052	6.79
2014			
Disclosure Group	1.54	0.31	5.17
Non-Disclosure Group	1.41	0.28	5.74
2013			
Disclosure Group	3.85	0.64	6.17
Non-Disclosure Group	2.67	0.49	5.83
2012			
Disclosure Group	1.88	0.26	7.00
Non-Disclosure Group	1.72	0.29	6.45

This slide provides analysis of the performance of disclosing versus non-disclosing firms in relation to two important benchmarks with which asset managers have challenged us. First, *mean excess returns* captures the performance of firms relative to the risk free rate. The second, the *Sharpe Ratio*, helps us to understand the return of an investment compared to its risk and is the most widely used method for calculating the risk-free return. On both measures, the human capital disclosing firms outperform non-disclosing firms in five and four of the six years (2012-17), respectively. Human capital disclosure is, then, financially material in the terms of the asset management's own industry standard.

Source: S&P 500, Analysis by Lancaster University Management School

UK: HCRI signals relative employee out-performance

N=100

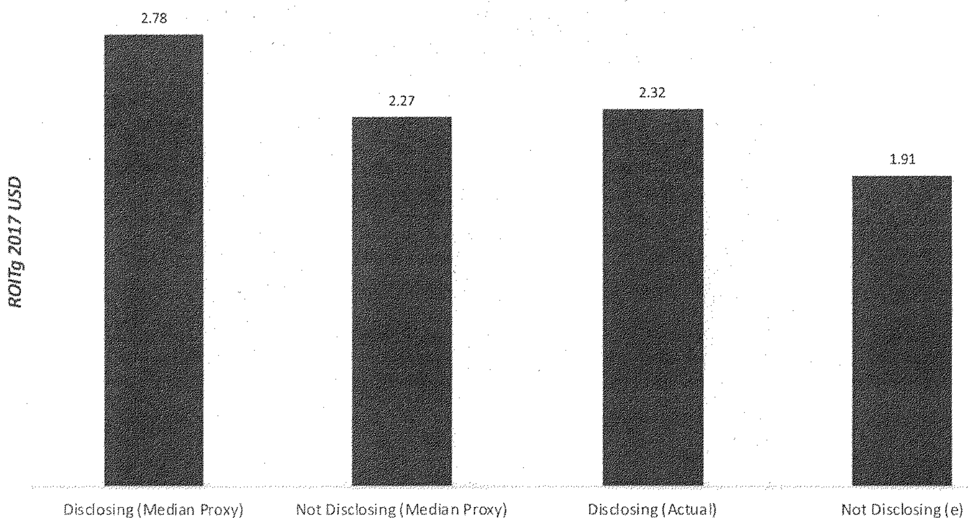


These data are compiled from HCR scores of equal weighting across all five variables and splitting firms into overall score quartiles. HCR appears to signal firms securing higher productivity from their employee base disclose more human capital related data. This suggests we cannot rule out human capital factors as a leading indicator of out-performance.

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School for EPIC

US: HC cost disclosers more productive than non-disclosers

N=350

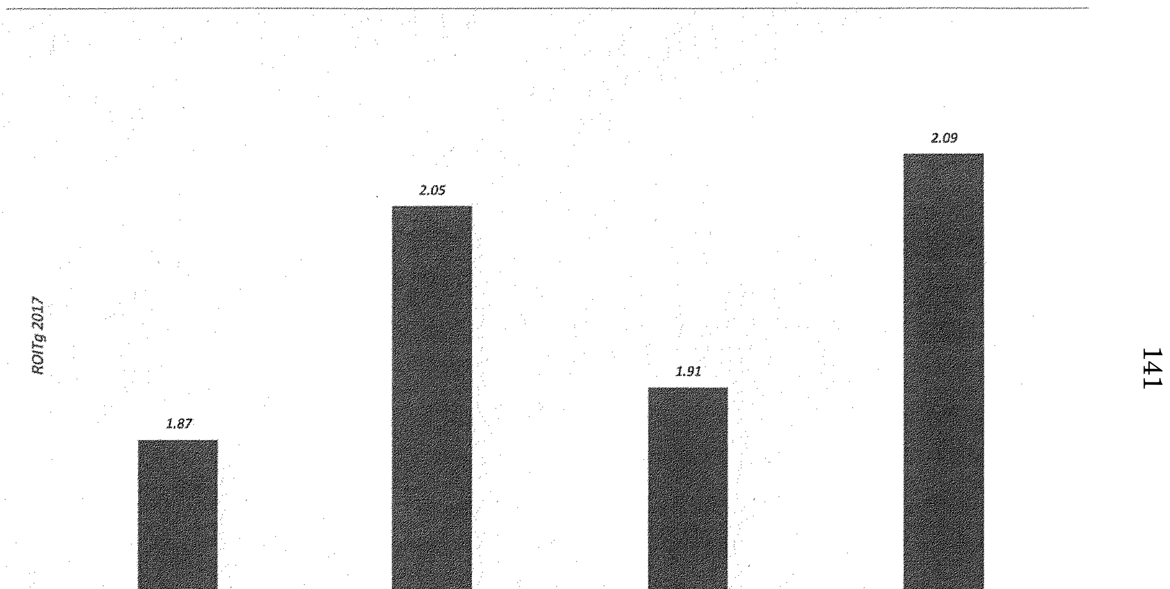


Using a comparative measure developed by Lancaster University called *Return On Invested Talent (ROIT)*, which measures the $ return per $1 invested in talent and associated charges, reveals those who disclose their HC costs secure higher levels of productivity than those who do not disclose details. This was established in two ways. First, the returns of disclosers and non-disclosers were compared using the median employee's pay now required in 2018 Annual Proxy Statement forms. This revealed a 23% difference in ROIT between disclosers and non-disclosers. This was augmented by a second approach developed by the SRG team at Lancaster University to model the costs of non-disclosers, revealing a 22% in ROIT between disclosers and non-disclosers.

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School for EPIC

US: HCR Index less mature but impactful

N=100

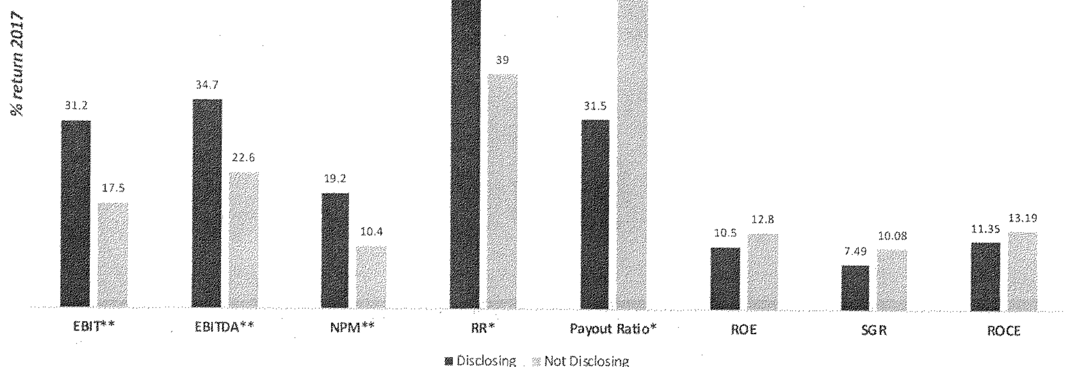


The linear relationship between employee productivity and human capital reporting is less pronounced in the US, perhaps reflecting the relative under-performance of information on human capital-related factors. Nevertheless, those firms in the Top S&P 100 by revenues with the highest scores secure higher levels of productivity from their employees than those in other quartiles.

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School for EPIC

Value creation v value transfer

N=75/495



Reading from left to right, this chart illustrates how value creation and value transfer differ between those firms who disclose their human capital costs (n=75) and those who do not. Firms disclosing their HC costs perform strongly in value creation, whereas those firms not disclosing their costs offer their shareholders higher rates of returns, but not significantly so. These findings are broadly repeated across the last three years (2015-17) with the pattern then breaking down pre-2015, suggesting modification in the underlying decisions made by disclosers versus non-disclosers in the last several years.

Source: S&P, Compustat & firm publications, Analysis by Lancaster University Management School for EPIC

Human Capital Disclosure – Narrative Reporting

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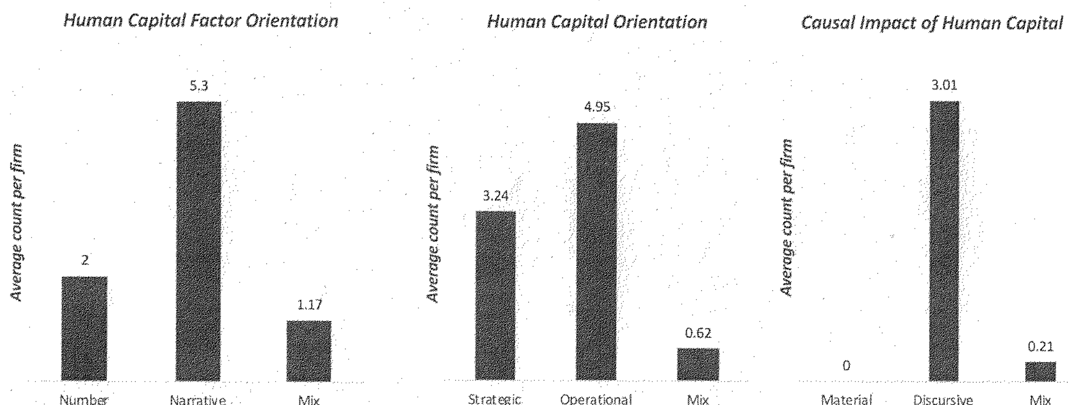
US: Narrative content analysis

N=100

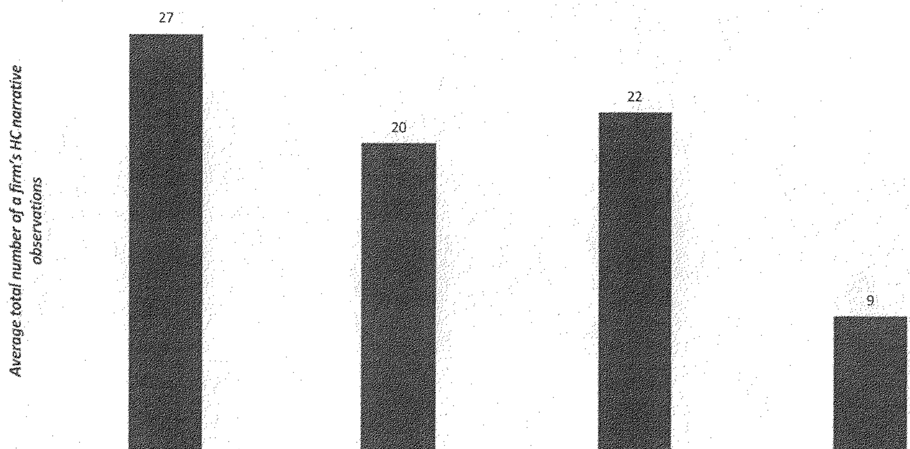
Source: S&P, Compustat & firm publications, Analysis by Lancaster University Management School for EPIC



Our analysis of the narrative elements used in in Annual Reports, Form 10-ks, and other firm publications reveals a clear emphasis on text as opposed to number to convey human capital information. The narrative form is preferred to number when reporting on human capital factors and in relation to the causal impact of human capital interventions. There is an orientation to operational description as opposed to conveying the strategic importance of human capital interventions.

US: HC disclosers let the numbers do the talking

N=100

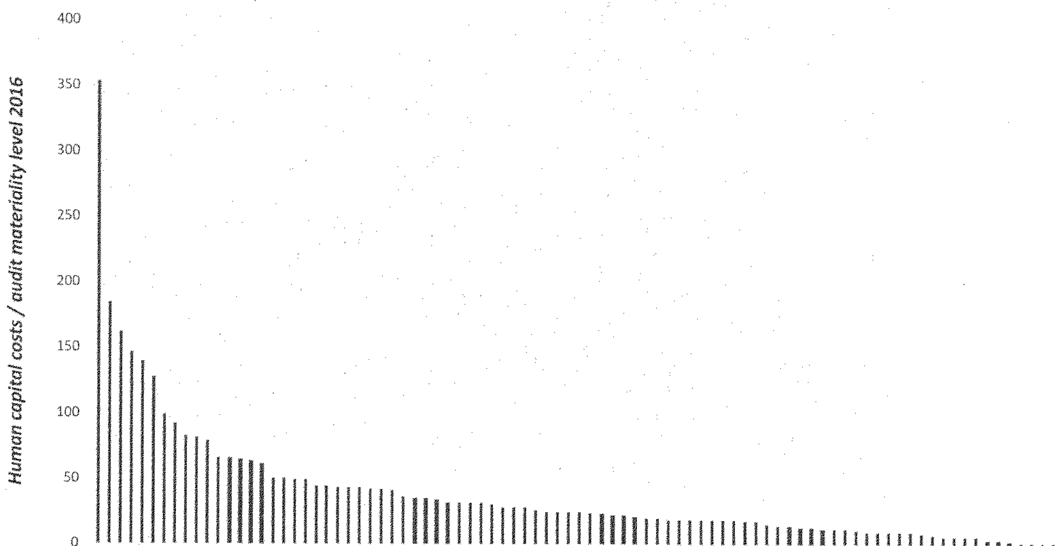


Examining the total number of narrative observations relating to their human capital deployment, we can clearly see how those firms in the upper quartile of human capital disclosure (right hand side), make fewer narrative observations. Clearly, these firms are letting their human capital deployment numbers do the talking for them. Clearly, there is scope for greater efficiency in human capital disclosures via tighter prescription of the required human capital disclosure data points..

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School for EPIC

UK: The materiality of human capital

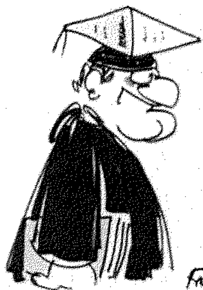
N=100



More than 4/5 firms in the FTSE 100 spend more on their human capital than their formally stated and audited level of materiality. Half FTSE 100 firms exceed this materiality level by greater than a factor of 20, underlying the fiduciary requirements of greater transparency relating to the reporting of human capital management.

Source: FTSE100 & firm publications, Analysis by Lancaster University Management School

ANTHONY HESKETH, UNIVERSITY MAN:



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Human Capital Factors in the Workplace

May 2019

Lori Foster[a,b]
Dan Ariely[b,c]
David Van Adelsberg[c]

There's no question that treating employees well is a moral imperative. Beyond that, the questions for businesses and investors are threefold. First, *Is it good for business?* Does it also pay, financially, to treat employees well? Second, *Which way of treating employees well is good for business?* Exactly which people-centered practices provide a long-term value for the employer and employee alike? And Third, *Should treating employees well be mandated?*

Research in psychology and behavioral economics speaks to these questions. There is cumulative evidence that treating employees well is good for business. However, the secret to human motivation is not so simple. There are many ways to create motivation. Some of them are better, healthier, and more profitable than others. The best ways to create motivation are not necessarily intuitive to businesses. Below, we elaborate and illustrate. There is a logic that shapes workplace motivation, but that logic is often hidden to employers and employees.

One key to understanding workplace motivation is the distinction between maximal and typical performance. Maximal performance is what an individual or team is fully capable of. Conversely, typical performance is less than the best effort. It is what employees exhibit at work when they are not fully engaged. Typical performance may be enough to keep one's job, but it holds people and organizations back from reaching their full potential.

Relatedly, a distinction can be drawn between task performance and contextual performance, which is sometimes called organizational citizenship behavior (OCB). OCBs include things like staying at work late, helping a coworker, and pitching in when it is not required, including helping with things that are not specified in one's formal job description. OCBs contribute to both the financial bottom line and employee wellness. People who engage in OCBs experience more meaningfulness at work, which leads to increased levels of energy and vigor at the end of the day.[1] Importantly, these positive outcomes occur when OCBs are optional or discretionary – not when they are mandated or forced. In fact, research has shown that requiring OCBs can backfire. Requiring employees to engage in organizational citizenship behavior leads to more counterproductive work behaviors that harm the organization and/or its members such as theft, sabotage, or working more slowly than necessary.[2]

What prompts people to perform better than necessary – to engage in OCBs and approach the maximal performance they are capable of? In large part, motivation. Workers are motivated in productive ways that simultaneously contribute to their own wellness and organizational performance when organizations operate in a manner that contributes to – rather than stifles – the fulfilment of certain fundamental human needs. Self-Determination Theory holds that each of us has three basic psychological needs—for *autonomy* (freedom to choose), *competence* (effectance; mastery), and *relatedness* (belonging). Work

[a] North Carolina State University
[b] Duke University
[c] Irrational Capital

settings that satisfy rather than thwart these needs are where we see more OCBs, more autonomous motivation, higher quality performance, wellness, and in the private sector, better returns for shareholders.

Consider the following example illustrating how work can support our need for relatedness to the benefit of all involved. At Intel, we studied the motivation and productivity of people working in 12-hour shifts to assemble computer chips[3]. They worked for four days in a row, followed by four days off. We tested different ways of improving workers' motivation and productivity upon coming back to work after four days off. Employees were randomly assigned to receive one of several different kinds of incentives for reaching a challenging manufacturing goal on their first day back at work. Some were told they would receive the equivalent of a $25 bonus. Others were incentivized by a family meal pizza voucher. Still others were informed they would receive a verbal reward from their senior manager, praising them for a job well done. The question was: *Would these incentives work in the short run?* And perhaps more importantly, *Would their effects persist over time even after the incentives were removed?* Results showed that compared to typical baseline performance, productivity increased on the first day back for employees in each of these incentive conditions. Incentives worked in the short run, moving employees from typical toward maximal performance. However, less intuitively, the monetary incentive backfired over time. We looked at employees' performance on the second, third, and fourth day back, after the incentive was removed. The productivity of those who had received a monetary incentive dropped *below* the baseline level of typical performance demonstrated before the incentive program was put into place. In contrast, the positive effect of the verbal praise from the boss persisted. Verbal praise is a way of supporting the relatedness needs of employees, described earlier. Those who had received a verbal reward from their senior manager continued to perform above baseline levels even after the incentive was removed. Interestingly, the performance of those who received a pizza voucher was somewhere in between. It was a little lower than the performance of those who received verbal praise, but it was significantly better than those who had received a cash incentive on the first day. We think the pizza incentive would have worked better if an actual pizza (rather than a voucher) had been delivered to employees' homes at the end of their first day back at work, thus supporting relatedness by allowing employees to receive salient, immediate recognition in the eyes of their families.

Self-Determination Theory holds that motivation can vary not only in terms of quantity but also in quality. Not all motivation is created equal. In particular, there is a difference between autonomous and controlled motivation. Autonomous motivation is characterized by people working with a full sense of willingness, volition, and choice. "When individuals understand the worth and purpose of their jobs, feel ownership and autonomy in carrying them out, and receive clear feedback and supports, they are likely to become more autonomously motivated and reliably perform better, learn better, and be better adjusted"[4].

Helping people find meaning in what they do creates higher levels of motivation. This is illustrated by a simple example. In an experiment, we paid participants $2.00 to use Lego pieces to assemble figures[5]. They were given instructions on how to build the figure from the Legos. After assembling the Lego figure, they were given the option of assembling another one for less money. It was up to them whether to proceed or quit. This continued for as long as they wished; each participant could work as long and hard as they wanted. Half of the participants were randomly assigned to a more meaningful condition where each Lego figure, upon completion, was placed on the desk in front of them. They could see their progress through the accumulation of assembled Lego figures. This progress gave some meaning or purpose to their work – a sense of accomplishment. The other half of the participants were randomly assigned to a condition where each Lego figure they built was disassembled in front of them as they were working on the next one. It was clear that their work was pointless; if they chose to continue beyond the second

round, they were simply re-assembling pieces they had already assembled before. The task requirements and wage schedule were identical in the two conditions. In purely rational economic terms, the costs and benefits were the same. Yet, the participants in the first, more meaningful condition demonstrated far more motivation. They chose to work longer and produce more. Stripping even the small amount of meaning from this relatively trivial task had a demotivating effect such that participants in the second condition quit sooner. Meaning, purpose, and a sense of accomplishment are important to work motivation.

An understanding of autonomous motivation is especially important in today's knowledge economy marked by an increasing need for lifelong learning due to the rapidly changing nature of work. In such an environment, autonomous motivation is arguably a business imperative. The opposite of autonomous motivation is motivation that is controlled. "When motivation is controlled, either through contingent rewards or power dynamics, the extrinsic focus that results can narrow the range of employees' efforts, produce short-term gains on targeted outcomes, and have negative spillover effects on subsequent performance and work engagement."[4] This explains why extrinsic rewards sometimes backfire, as we saw at Intel, leading to reduced motivation and lower performance in the long run. Under certain circumstances, rewards can crowd out autonomous motivation. Extrinsic rewards such as bonuses will ultimately undermine performance when they "shift people's perceived locus of causality or perceived competence, thus diminishing their sense of autonomy and/or their sense of competence"[4]. In other words, when people begin to interpret their own hard work as a response to someone else's demands or enticements rather than their own self-determined interest or desire, the quality of their motivation and performance will ultimately deteriorate.

There is also something to be said for fairness at work. Years of research on organizational justice and equity suggest that people are motivated by fairness. Lack of fairness has negative consequences. Meta-analyses have shown that people who perceive procedures, relationships, and outcomes such as pay raises as unfair perform worse, are less inclined to engage in OCBs, and are more likely to demonstrate counterproductive work behaviors such as those described previously.[6,7,8] Fairness violations hurt people psychologically, and they hurt companies in terms of profitability.

In sum, there is no question that treating employees well is very important. Research clearly shows that doing so improves human motivation, productivity, wellbeing, and overall performance. Employers who operate in ways that promote fairness, support autonomous motivation, and allow people to develop and grow will see returns on their human capital investments. These principles hold across different types of workers and organizations. However, there is variation in exactly how these principles express themselves in different organizational settings and over time given the rapidly changing nature of work.

Given the power of supporting autonomous motivation at work, should treating employees well be mandated? To do so would require a specific form of measurement and monitoring, which could inadvertently introduce a counterproductive dynamic. There is no question that human motivation is of central importance, and employers should pay close attention, including measuring motivation in a range of ways. However, requiring a specific form of measurement can hinder rather than increase companies' abilities to continuously innovate, explore, and improve employee wellbeing in ways that impact and increase shareholder value. Moreover, it is reasonable to assume that companies' ability to assess and motivate their employees should be a main differentiating force in the marketplace.

[1] Lam, C. F., Wan, W. H., & Roussin, C. J. (2016). Going the extra mile and feeling energized: An enrichment perspective of organizational citizenship behaviors. *Journal of Applied Psychology, 101*(3), 379-391.

[2] Spanouli, A., & Hofmans, J. (2016). Walking the tightrope: Counterproductive work behavior as compensation for citizenship demands. *Frontiers in Psychology, 7*, 1-7.

[3] Bareket-Bojmel, L., Hochman, G., & Ariely, D. (2017). It's (not) all about the Jacksons: Testing different types of short-term bonuses in the field. *Journal of Management, 43*, 534-554.

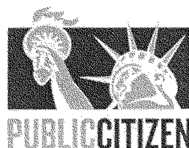
[4] Deci, E. L., Olafsen, A. H., & Ryan, R. M. (2017). Self-determination theory in work organizations: The state of science. *Annual Review of Organizational Psychology and Organizational Behavior, 4*, 19-43.

[5] Ariely, D., Kamenica, E., & Prelec, D. (2008). Man's search for meaning: The case of Legos. *Journal of Economic Behavior & Organization, 67*, 671-677.

[6] Colquitt, J. A., Conlon, D. E., Wesson, M. J., Porter, C. O. L. H., & Ng, K. Y. (2001). Justice at the millennium: A meta-analytic review of 25 years of organizational justice research. *Journal of Applied Psychology, 86*, 425-445.

[7] Colquitt, J. A., Scott, B. A., Rodell, J. B., Long, D. M., Zapata, C. P., Conlon, D. E., & Wesson, M. J. (2013). Justice at the millennium, a decade later: A meta-analytic test of social exchange and affect-based perspectives. *Journal of Applied Psychology, 98*, 199-236.

[8] Kanfer, R., & Chen, G. (2016). Motivation in organizational behavior: History, advances and prospects. *Organizational Behavior and Human Decision Processes, 136*, 6-19.



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Testimony
Bartlett Collins Naylor
Financial Policy Advocate
Congress Watch, a division of Public Citizen

For
The House Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

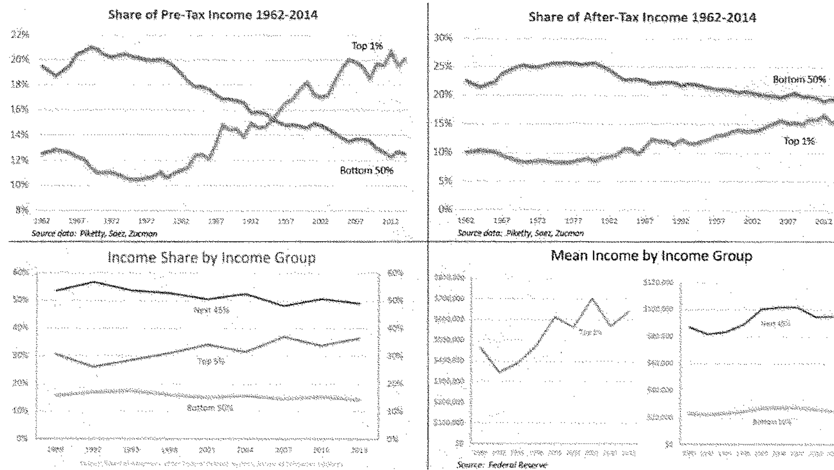
Hearing:
Promoting Economic Growth: A Review of Proposals to Strengthen the Rights and Protections for Workers

May 15, 2019

Chair Maloney, Ranking Member Huizenga, and and members of the subcommittee: On behalf of more than 500,000 members and supporters of Public Citizen, we offer the following comments regarding the legislative proposals advanced to promote economic growth through the protection of workers. Rachel Curley, also of Public Citizen's Congress Watch division, contributed to this testimony.

Our economy currently enjoys a period of prolonged growth, with rising GNP, relatively low unemployment, modest wage growth, and a strong stock market. Unfortunately, as has been the case for several decades, the fruits of labor have not been shared equitably. The fortunes of those in the senior ranks of corporations, especially the financial sector, pierce the ceiling of embarrassment; the financial fate of the vast majority of Americans has bordered on the bleak. The charts below developed by Thomas Piketty and the Federal Reserve document this disparity.[1]

[1] Bricker et al, *Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009 (PDF).* FEDERAL RESERVE BOARD, (2011) https://www.federalreserve.gov/pubs/feds/2011/201117/201117pap.pdf , also, Thomas Piketty, Capital in the 21st Century.



We believe Congress must adopt bold reforms to address this yawning income gap. This will include governance changes to the way how corporations concentrate revenues generated by their workforce into senior executive pay, which is the purview of this subcommittee. First, we review the proposals now before the committee; second, we will outline some of these additional needed reforms.

Proposed Legislation

This hearing addresses some important first steps towards rectifying this maldistribution of income.

1. The Outsourcing Accountability Act,

Sponsored by Rep. Cynthia Axne (D-Iowa), this measure requires publicly traded companies to disclose the total number of workers they employee in each state and in each foreign country. This will help inform policy makers and investors about the geographic strategies of the nation's larger corporations. This information is already known to these companies, making disclosure simple.

2. A bill to amend the Securities Exchange Act of 1934 to require issuers to disclose information about human capital management in annual report

Also sponsored by Rep. Axne, this legislation will expand reporting of a firm's investment in its workforce and certain intangible assets. Increasingly, the value of a firm consists not in its factories or inventory but the quality of its workforce. An investor may wish to know more about such firms where most of the assets essentially disappear at the end of a work day. According to one study, "about 3/4 of the value of public companies, as perceived by investors, reflects nonphysical and nonfinancial assets.

Much of this huge value constitutes intangibles that are absent from the balance sheet."[2] Firms with superior human capital management (HCM) enhance company performance and share value.[3] Two portfolios of large-capitalization companies launched in 2001 and 2003 using criteria related to training and employee development outperformed the S&P 500 on an annualized basis by 3.1% and 4.4%, respectively, through May 25, 2010.[4]

To date, however, the Securities and Exchange Commission (SEC) requires minimal information regarding employees. Specifically, under Regulation S-K, only one item addresses the issue, and mandates the disclosure of the "number of persons employed." The only other item is the median pay of workers.

Public Citizen supports the Human Capital Management Petition filed with the SEC by the Human Capital Management Coalition on July 6, 2017.[5] This will enhance disclosure. And we thereby support this Axne legislation that calls upon the SEC to implement this rule.

In addition, Public Citizen supports comprehensive disclosure rules around all corporate environmental, social, and governance (ESG) risk from climate change, political spending, tax, human rights, to gender pay ratios. To that end, we supported a new petition for a rulemaking[6] at the SEC from securities law experts and investors representing more than $5 trillion in assets under management that would create a standard disclosure framework on all ESG issues for public companies.

Public Citizen urges the SEC to begin work on this rulemaking and would support legislation from Congress that mandates this rule.

3. A bill to require the SEC to study stock buybacks under rule 10b-18

This measure takes a welcome step to address the glut of stock buybacks that have accelerated since the SEC relaxed anti-manipulation rules in 1982. On the surface, a stock buyback represents a declaration of management indolence. Firms issue stock to raise capital for growth, for the expansion of existing production, for the research and development of new products. When managers repurchase stock, they are confessing they have no new promising ideas. In fact, this apparent humility may mask a darker motive: stock buybacks raise stock prices, and when senior executive pay is paid in stock options, this can generate an unjustified bonus.

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[2] Baruch Lev "*Intangible Assets: Concepts & Measurements*" NYU ENCYCLOPEDIA OF SOCIAL MEASUREMENT, VOL 2 (2005) p 299. Available at: http://raw.rutgers.edu/docs/intangibles/Papers/Intangible%20Assets%20Concepts%20and%20Measurements.pdf.
[3] See, for example, Beeferman, Bernstein "*The Materiality of Human Capital to Corporate Financial Performance*" IRRC AND THE KENNEDY SCHOOL (April 2015) http://www.law.harvard.edu/programs/lwp/pensions/publications/FINAL%20Human%20Capital%20Materiality%20April%2023%202015.pdf.
[4] Laurie Bassi & Dan McMurrer, *Human Capital Management Predicts Stock Prices*, AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT (June 2010) (http://mcbassi.com/wp/resources/documents/HCMPredictsStockPrices.pdf)
[5] *Letter to SEC from Public Citizen re Human Capital Management Petition*, SECURITIES AND EXCHANGE COMMISSION (Sept. 27, 2017) https://www.citizen.org/wp-content/uploads/migration/case_documents/public_citizen_comment_on_hcm_petiton.pdf
[6] *Request for rulemaking on environmental, social, and governance (ESG) disclosure*, SECURITIES AND EXCHANGE COMMISSION, (website viewed on March 28, 2019). https://bit.ly/2Pg52qz

President Trump and congressional Republicans sold the recent corporate tax cut law as a stimulus for corporate investment in higher worker wages and enlarged production facilities. In fact, the single largest use has been stock buybacks.[7] When a corporation buys stock, it should be governed by the maxim that applies to any investor: buy low, sell high. Yet the stock market has been at a record high level during this frenzy of corporate stock buybacks, contradicting any claim that these are sound business decisions. Commission Robert Jackson of the SEC found that corporate insiders were inexplicably active sellers following a buyback announcement,[8] buttressing the concern about manipulation. Clearly, the motives behind these stock buybacks must be examined. This bill aims to clarify those motives and we therefore support it.

Public Citizen also endorses several affirmative efforts to reform this abuse. Congress should begin by repealing the 1982 Rule 10b-18, which relaxed anti-manipulation safeguards. We support the Reward Work Act, sponsored by Sen. Tammy Baldwin (D-Wisc), which does reform 10b-18. It would also empower workers to elect a third of a company's board of directors.[9] Public Citizen also supports a bill authored by Sen. Bernie Sanders (S-Vt) and Rep. Ro Khanna (D-CA) that would prohibit buybacks where CEO pay exceeds 150 times that of the company's median pay. We also support a rule from the SEC that would require that shareholders approve buybacks, rather than directors. Finally, Congress should simply ban executive stock sales during buybacks altogether.

4. Greater Accountability in Pay (GAP) Act of 2019

Sponsored by Rep. Dean Phillips (D-Minn.), this measure requires firms to show the change in median pay at publicly traded firms each year, compared with the change in CEO compensation. Public Citizen has actively supported the underlying disclosure provided in Section 953b of the 2010 Wall Street Reform and Consumer Protection Act that this bill expands.[10] This modest disclosure of the pay gap helps investors better understand how a firm invests in its most critical driver of revenue — employees.[11]

We encourage the committee to consider additional disclosures and rules. We support disclosure of pay by gender and race to help policy makers appropriate shape incentives. Policymakers should use the power of the public purse to incentivize narrower pay gaps. Congress should ban contracts to corporations with extreme gaps or give preferential treatment to firms with narrow gaps, as proposed in Rhode Island.[12] Similarly, all forms of corporate welfare should be required to incorporate pay ratio guidelines in their qualification standards. As a member of Congress, Mick Mulvaney authored legislation designed

[7] *Wage Growth Tracker*, FEDERAL RESERVE BANK OF ATLANTA (April. 15, 2019) https://www.frbatlanta.org/chcs/wage-growth-tracker.aspx
[8] Comm. Robert Jackson, *Speech at the Center for American Progress,* SECURITIES AND EXCHANGE COMMISSION (Jun. 11, 2018), https://www.sec.gov/files/speech-jackson-061118-data-appendix.pdf.
[9] *Reward Work Act*, press release, OFFICE OF SEN. TAMMY BALDWIN (website visited May 13, 2019) https://www.baldwin.senate.gov/press-releases/reward-work-act-2019
[10] Letter to SEC, Public Citizen (March 29, 2018) https://www.citizen.org/wp-content/uploads/migration/public_citizen_on_sec_pay_ratio_data_integrity.pdf
[11] *Letter to SEC*, Public Citizen, SECURITIES AND EXCHANGE COMMISSION (July 6, 2015) https://www.sec.gov/comments/s7-07-15/s70715-44.pdf
[12] Sarah Anderson, How Taxpayers Subsidize Giant Corporate Pay Gaps, Institute for Policy Studies (August 29, 2018) https://ips-dc.org/wp-content/uploads/2018/08/EE18-embargoed-until-aug-29.pdf

to prevent the U.S. Export-Import Bank from subsidizing any U.S. company with CEO pay greater than 100 times median worker pay. [13]

Needed Reforms

In addition to these measures, we urge the committee to consider additional steps. We believe that unbridled escalation of CEO pay both reflects and causes serious economic injury. High executive pay drains income from lower wage workers. Excessive pay led to the 2008 Wall Street crash, where the CEOs of failed Lehman and Bear Stearns earned hundreds of millions. Exorbitant pay is corrupting medicine.[14] And as noted, high stock-based pay leads to buybacks instead of investment in factories and human capital. These serious problems demand stern answers.

Many reforms involve shareholder governance. Shareholders legally decide how senior managers are paid, but current rules don't allow for true shareholder control.

Say-on-Pay Director Accountability

By law (Dodd-Frank Section 951), corporations must seek a shareholder vote on the compensation package for the CEO. Unfortunately, the current vote is non-binding, meaning that even if a majority disapprove, no changes are required. Say-on pay votes should be binding. In addition, there should be an additional incentive to ensure good packages. Where shareholders oppose the package, the pay should revert to 20 times the median pay at the company, and director compensation should be cut in half.[15]

Proxy Access

Directors set executive pay, yet these directors don't necessarily reflect shareholder interests since there is no true election; shareholders only vote on one set of candidates. We propose a ballot that shows multiple candidates for each position, a policy endorsed by the Council of Institutional Investors.[16]

Worker board directors

We support worker representation on boards, and endorse the Accountable Capitalism Act, sponsored by Sen Elizabeth Warren (D-Mass). In a recent poll, of likely U.S. voters, 52 percent were supportive of putting workers on boards of large corporations and only 23 percent were opposed.[17] In at least a dozen European countries, workers have the right to representation in their company's top administrative and management bodies.[18] This has had a moderating effect on CEO pay levels. In Germany, average CEO pay levels, while hardly stingy, were less than half the U.S. average in 2016.[19]

Defer banker pay for penalties

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[13] Robert Schroeder, *Republican Aims To Block Ex-Im Aid To Companies With Hefty CEO Pay*, MARKETWATCH (Nov. 3, 2015) https://www.marketwatch.com/story/republican-aims-to-block-export-import-aid-to-companies-with-hefty-ceo-pay-2015-11-03

[14] Martin Shkreli quadrupled drug prices to fund his high pay.

[15] Dean Baker, *High CEO Pay*, CENTER FOR ECONOMIC POLICY RESEARCH, (March 26, 2018) http://cepr.net/publications/op-eds-columns/high-ceo-pay-it-s-what-friends-are-for

[16] Proxy Access, Council of Institutional Investors, (website visited May 13, 2019) https://www.cii.org/proxy_access

[17] *The New Progressive Agenda Project*, DATA FOR PROGRESS (website visited May 13, 2019) https://www.dataforprogress.org/the-new-progressive-agenda-project/

[18] *Co-Determination in Germany*, HANS BOEKLER (Juane 2009) https://www.boeckler.de/pdf/p_arbp_033.pdf

[19] Anders Melin, *Executive Pay*, BLOOMBERG (Jan 23, 2018) https://www.bloomberg.com/quicktake/executive-pay

Following the 2008 financial crash, the Justice Department found widespread fraud. However, prosecutors brought no charges against any senior individuals. Some officials cited the complication of identifying culpable individuals. That left shareholders to shoulder the fines. To improve compliance, we call for the system advocated for by Willian Dudley, then president of the New York Federal Reserve, which says that senior bankers (such as the 2,000 most senior at JP Morgan) must defer a substantial portion of pay.[20] If the bank must pay a penalty, this pool is used to pay the fine instead of shareholder funds. This will motivate managers to police one another.

No stock options for bankers

Structuring pay to motivate executives to take risks may be healthy for some firms, but it can lead to disaster at banks. Bankers should not be paid in stock options. The EU rules introduced in 2014 limit banker bonuses to no more than annual salary, or up to 200 percent of annual salary with shareholder approval. The cap applies to bankers in non-EU banks located in the EU, as well as senior staff (including Americans) working for EU-based banks anywhere in the world. This reform aims to help counter the "bonus culture" that encourages high-risk investing. Regulators are working to crack down on some banks that have been circumventing the new rules by raising base salaries and converting bonuses into "allowances."

Banker stock options should be banned, but short of that, they should at least be kept (and not cashed in) for at least two years after retirement. This deters banking that yields short term profits at the expense of long-term problems.

CEO pay limit for firms in bankruptcy

Executives should not be able to pocket huge bonuses after declaring bankruptcy and cutting jobs and pensions. Policymakers should eliminate loopholes in existing law and prohibit companies in bankruptcy from awarding "retention" bonuses. For example, a senior executive should not be paid a bonus unless the executive is offered the same or higher pay from an outside employer.

Private equity executives should not bankrupt companies and therein terminate employee pension benefits as a means of increasing their own profits. These executives should be barred from receiving any pension or pension-like benefits unless pensions and severance funds for operating companies are fully funded.

Again, we thank the subcommittee for beginning to address the needs of workers as it refashions securities laws. We look forward to a continuing dialogue about needed progress.

For comments or questions, please contact Bartlett Naylor at bnaylor@citizen.org.

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[20] Bartlett Naylor, *Decimate Wall Street,* HUFFINGTONPOST (Dec. 22, 2014) https://www.huffpost.com/entry/decimate-wall-street_b_6029372?guccounter=1

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Hunting High and Low: The Decline of the Small IPO and What to Do About It

Marshall Lux and Jack Pead

April 2018

M-RCBG Associate Working Paper Series | No. 86

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Hunting High and Low[1]: The Decline of the Small IPO and What to Do About It

Marshall Lux and Jack Pead

Abstract

Since the bursting of the dot-com bubble in 2000, the annual number of initial public offerings in the U.S. has fallen and not recovered. Since that year, the number of IPOs has averaged 135 annually, less than a third of the average in the 1990s. That decline has long been viewed as a problem that threatens American technological innovation, job creation and competitiveness. This paper surveys the by-now extensive research and debate about IPOs, particularly tackling the question of identifying the factors behind the decline. This is not a simple problem. Multiple factors appear to have played a role not just in the recent decline in IPOs, but in the surge in number and volume of IPOs that began in the early 1980s. These factors include a financial system that features greater scale and consolidation in both financial intermediaries and institutional investors; the fallout from the Eliot Spitzer-led Global Analyst Research Settlements in 2003, which left many smaller startups without research coverage; the rise of private capital, from private equity to liberalized rules on other forms of private capital offerings; a shift in institutional investing from active to passive strategies; and an increasing burden of regulation on all public companies. It's quite clear that the locus of the problem is with smaller companies that struggle to get coverage from the sell side and that feel a disproportionate burden from regulation like Sarbanes-Oxley than larger corporations. Two broad trends dovetail here: There is more private capital to support private startups than in the past, and the challenges of management in the public arena are complex, with high levels of M&A, activist investors, enhanced regulation, personal liability for managers and directors, and the perception of a short-term perspective in a shareholder-centric governance system. We offer a number of regulatory recommendations to ease the burden. We also ask the question: Given the larger context of changing and diversifying equity and capital markets, is the decline in IPOs since the '90s a serious issue or a reflection of more diverse equity markets that offer a multiplicity of paths forward?

[1] A-ha, 1985.

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Acknowledgments

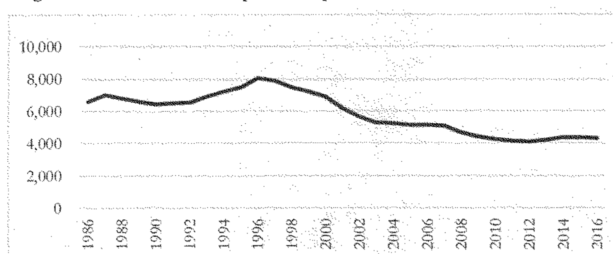
A paper seeking to undertake a nuanced analysis of what is a complex phenomenon would not be possible without the support of those with varying perspectives on the issue. We would like to express our gratitude to Robert Greene at Patomak Global Partners for spurring the line of inquiry which led to the development of this paper and for his continued support. As in prior years, the support of the Mossavar-Rahmani Center for Business and Government at the Harvard Kennedy School and the wider Harvard community has been critical in not just allowing us to do this work, but to do it well. In particular, we would like to thank Bob Glauber, John Haigh, Richard Zeckhauser, Scott Leland and Susan Gill for their advice, encouragement and support. We'd like to thank Jon Korngold at General Atlantic for his thoughts. Finally, we thank Vladimir Ivanov and Scott Bauguess at the SEC for assisting us with our inquiries and allowing us to unearth new data on private offerings.

1. Introduction

The initial public offering has long been associated with the vitality of the U.S. capital markets. But since 2000, near the height of the dot-com bubble, the number of IPOs began a long decline. The average annual number of IPOs fell by over 61% between the 1990s and the 2000s.[2] Certainly, in the late 1990s and the early 2000s, IPOs were inflated by the waves of internet and tech companies rushing to sell public shares and cash out their venture capital backers. Yet, as our research finds, the sharp decline since that time is hardly just a correction in the IPO market, but represents a more persistent, longer-term trend. In fact, the decline in IPOs persisted throughout the recession that followed the dot-com bust, through the subsequent recovery, through the market collapse that led to the Great Recession, and through the nearly decade-long recovery.

In this paper, we aim to explore the factors that have driven what appears to be a new normal in IPO levels in the U.S. We find that the overall decline in IPOs between 2000 and today is largely the result of a dramatic fall in the number of small IPOs, those below about $100 million. Throughout this period, a complementary trend has also occurred, with the number of public companies falling by 46% between 1996 and 2016—from some 8,090 to just 4,331.[3] We explore a number of causes shaping these trends and conclude that both market and regulatory factors are responsible.

Figure 1: Number of domestic public companies, USA, 1986–2016.



Source: World Bank

Understandably, the decline in IPOs and the number of publicly listed companies has triggered a search for an explanation as well as demands for policy action. Policymakers from both parties have argued that the decline in IPOs and public companies is cause for concern. In 2012, Congress passed the bipartisan Jumpstart Our Business Startups Act (the JOBS Act). As explained in Part 4, the legislation has helped to bolster small companies' access to public and private capital markets. But as our research shows, more can be done to revitalize public capital markets. As then-newly named Securities and Exchange Commission Chairman Jay Clayton stated in July 2017, "Many of our country's most innovative businesses are opting to remain privately held" and, in order to reverse the trend, "we need to increase the attractiveness of our

[2] Bloomberg. The average number of IPOs per annum from 1990-1999 was 529. This number fell to 205 during the period 2000-09.

[3] "Listed Domestic Companies, Total, United States," The World Bank, World Federation of Exchanges database, accessed Dec. 18, 2017, https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US.

public capital markets."[4] Importantly, Clayton noted, any reform aimed at making public markets more attractive should do so "without adversely affecting the availability of capital from our private markets."[5]

In Part 5, we present strategies to do just that. Certainly, non-policy factors—including financial innovations and changes in investor preferences—have driven the decline in IPOs. Yet to the extent that regulatory policy is discouraging public equity offerings and impeding investor choice, the SEC and Congress should reexamine those policies. We conclude our study by identifying a number of policy reforms that could improve the health of the public capital markets without undermining the appeal of the private capital ecosystem.

2. Why IPOs Matter

IPOs are just one aspect of a complex financial ecosystem that has developed organically over time. An IPO on the New York Stock Exchange or the Nasdaq represents the debut of a company in the public equity markets. With $29 trillion in total market capitalization at year-end 2016, the U.S. equity markets are the largest single segment of the U.S. capital markets, more than double the size of the market for U.S. Treasuries.[6]

The first IPO that resembles a market vehicle we would recognize today took place in the Netherlands in 1602, with the public offering of shares in the United East India Company, which in turn led to the founding of the first modern stock market, the Amsterdam Stock Exchange.[7] In the U.S., IPOs experienced dramatic growth in annual numbers only in the 1960s.[8] Multiple factors fueled the growth and construction of a robust, if often volatile, technology-driven IPO market. First, in the 1950s, institutional investors began shifting their investing focus from bonds to stocks.[9] The fears going back to the Great Depression about the safety of stocks had faded, particularly as institutions adopted modern portfolio theory—building diversified portfolios that included allocations of higher-risk equity, like shares of companies undergoing IPOs.[10] Institutions, particularly corporate and public pension funds, were growing rapidly in an affluent U.S. with a large Baby Boomer generation coming of age. Second, a professionalized venture capital industry had developed after World War II (often backed by institutional funds) and was channeling its capital into startups, many of them companies exploiting the latest technological advances, like semiconductors and digital electronics.

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[4] SEC Chairman Jay Clayton. "Remarks at the Economic Club of New York." July 12, 2017. U.S. Securities and Exchange Commission, accessed Dec. 18, 2017. https://www.sec.gov/news/speech/remarks-economic-club-new-york.
[5] Ibid.
[6] "A Financial System That Creates Economic Opportunities: Capital Markets," U.S. Department of Treasury. Oct. 2017.
[7] Shiller, Robert. "ECON 252: Financial Markets (2011) Lecture 4 - Portfolio Diversification and Supporting Financial Institutions." Open Yale Courses, accessed December 18, 2017, http://oyc.yale.edu/economics/econ-252-11/lecture-4.
[8] Burhop, Carsten, and David Chambers, "8. Initial Public Offerings: A Historical Overview," Research Foundation Books 2016, no. 3 (Dec. 1, 2016): 132–46. https://doi.org/10.2470/rf.v2016.n3.11.
[9] Ibid.
[10] Burck, Gilbert, "A New Kind of Stock Market," *Fortune*, March 1959, p. 120.

After the recession and severe market slump of the '70s, when both venture capital and IPOs nearly submerged, the IPO market roared back in the early '80s.[11] IPOs became a key component of a sophisticated equity-capital market structure; this model is one many hearken back to when articulating concerns about flagging IPO numbers. Venture capital was organized to support and profit from a high-risk culture of startups, entrepreneurs and innovation. Venture stakes were illiquid and in time needed to be transformed into public shares, through acquisition or IPOs, if only so they could invest their capital into new high-risk, high-reward opportunities. Venture funds were relatively small, which fast-growing companies could quickly burn through.[12] To drive growth, many companies required the much greater and cheaper capital provided by public markets: permanent equity capital.

That transition from private to public involved a widely understood tradeoff. Venture capital funds could monetize their profits, and deserving companies could raise large amounts of public capital for growth.[13] However, this came at the cost of assuming new burdens, particularly on the regulatory front. Governance grew more complex. Rather than dealing with a board that consisted of a handful of venture capitalists, newly public firms had large shareholder bases, increasingly consisting of sophisticated institutions expecting steady share appreciation.[14] And new public companies discovered they had multiple stakeholders, including employees, customers and local communities, with their approach to management being closely and continuously scrutinized. The IPO process also introduced startups to Wall Street, the gatekeeper to the capital markets, and to regulatory oversight, particularly from the SEC, which mandated transparency and a complex disclosure regime.

In retrospect, this equity capital market structure was an increasingly intricate balancing of tradeoffs that had barely existed before the '60s and was in flux as early as the mid-'80s, with the explosion of financial innovations, from high-yield bonds to private equity, to rising levels of hostile M&A and the emergence of shareholder-centric governance, which altered the always-rocky path between venture-backed startup and public company.

Still, that model of the IPO became a popular ideal, closely associated with technological vitality and economic prosperity.[15] A robust IPO market became evidence of the underlying health of new-business creation; a sign that companies were maturing in ways that made entrepreneurs eager to trade ample public capital for the responsibility to shoulder regulatory burdens and be accountable to shareholders; and the fact that new companies gave investors, both institutional and retail, an opportunity to participate broadly in high-growth stocks. The health of the IPO became a litmus test for the health and dynamism of the economy. As a result, comparison in the number of IPOs has long been a key metric to signify, for good or bad, the competitiveness of New York versus Tokyo, London and, today, Hong Kong.[16]

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[11] Burhop, op. cit.

[12] Wilson, John W, *The New Venturers: Inside the High-Stakes World of Venture Capital*, Reading, Mass: Addison-Wesley, 1985.

[13] For a broad overview of the venture process, see Paul Gompers and Josh Lerner, *The Venture Capital Cycle*, MIT Press, 2006.

[14] Kahle, Kathleen M., and Stultz, Rene, "Is the U.S. Public Corporation in Trouble?" *Journal of Economic Perspectives*, Vol. 31, No. 3, Summer 217, p. 81.

[15] A comprehensive study from the Kauffman Foundation in 2012 on employment and revenue growth clearly delineated 1980-2000 as a distinct period in IPOs, then studied a slice of that, 1996-2000. See Kenney, Martin, Patton, Donald, and Ritter, Jay, "Post-IPO Employment and Revenue Growth for U.S. IPOs, June 1996-2010," Kauffman Foundation, 2012.

[16] Committee on Capital Markets Regulation, "The Competitive Position of U.S. Public Equity Markets" Dec. 4, 2007.

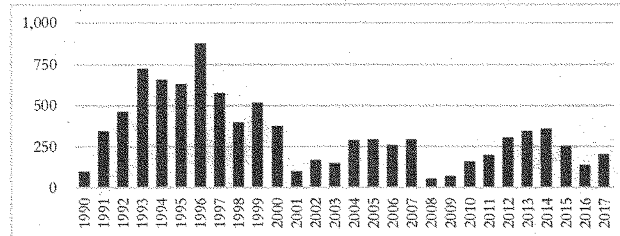
There were clearly benefits of a healthy IPO market. Research suggests that IPOs finance growth and stimulate innovation, productivity and job creation.[17] In fact, the broadest rationale for IPOs is the argument that they produce new companies generating the largest numbers of jobs. Many investors buy shares in IPOs in the belief that the company will generate an acceptable rate of return; while that's not always the case, the roster of companies that participated in high-profile IPOs—Intel, Apple, Microsoft, Amazon.com, Google, Facebook—is impressive and continues to drive the stock market. Apple has the highest market capitalization of any public corporation in the world.

Of course, many aspects of IPOs remain controversial: from the role of Wall Street firms that set IPO prices, which critics often view as either too low or too high (leaving money on the table or persuading investors to overpay), to the large number of IPOs that simply don't perform for public shareholders. These shouldn't be surprising. Price setting is an art, not a science. And IPOs of emerging companies are, by definition, risky. But tech stocks have been prone to bubbles and manias, from the sonics-and-tronics frenzy of the '60s to the dot-com bubble of the late '90s. In particular, the dot-com bust severely damaged both venture capital and the IPO market after bursting in mid-2000. And as we have seen, IPOs have never recovered to those heights since.

3. Examining the Decline in IPOs

The IPO market can be viewed from a variety of perspectives, including by the number of IPOs and the total amount of capital raised. These results can be segmented by size or sector. Looking at the market as a whole, since 2000 the average number of IPOs annually has fallen by over 60% from the levels seen during the 1990s.[18] We utilized Bloomberg data to examine the scope of this downward trend and the types of companies not inclined to raise funds via public capital markets.

Figure 2: Number of IPOs, USA, 1990–2017.



Source: Bloomberg

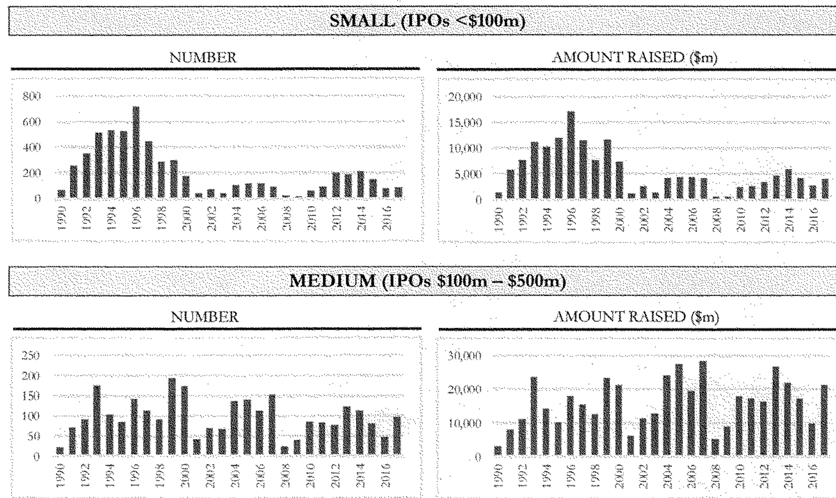
[17] Kenney, Martin, Patton, Donald, and Ritter, Jay, "Post-IPO Employment and Revenue Growth for U.S. IPOs, June 1996-2010," Kauffman Foundation, 2012.

[18] Bloomberg. The average number of IPOs per annum from 1990-1999 was 529. This number fell to 205 during the period 2000-09.

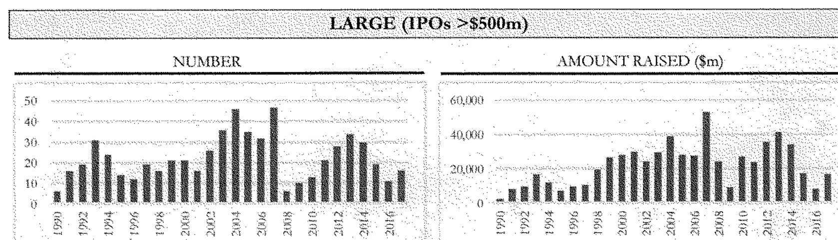
The immediate finding is that the number of offerings has fallen dramatically since 2000, which represents the end of an IPO boom that featured the public debuts of waves of internet and tech stocks. That boom resulted in the burst of the so-called dot-com bubble and a subsequent recession. Of course, the number of IPOs has fluctuated before. From 1973 (when the Nasdaq stock exchange, which focused on small, often tech stocks, launched) through 1980, the major exchanges averaged about 17 IPOs a year.[19] Those years did feature economic dislocation and falling markets after the boom years of the 1950s and 1960s.[20] IPOs then recovered in the 1980s, averaging 347 a year from 1983 to 1987.[21] After the recession of the late 1980s, IPOs took off in the 1990s, before coming to a fairly abrupt halt from 2001 onward.

In order to parse out the trends in IPOs by their relative size, we separated the IPO data into three categories: small (<$100 million), medium ($100 million to $500 million) and large (>$500 million).[22] We indexed these categories so they are based on real 2017 prices.[23] The segmented results are shown below.

Figure 3: IPOs segmented by size, based on 2017 real prices, USA, 1990–2017.



[19] Michelle Lowry, Roni Michaely, and Ekaterina Volkova, "Initial Public Offerings: A Synthesis of the Literature and Directions for Future Research" (Mar. 20, 2017), available at https://ssrn.com/abstract=2912354.
[20] Ibid.
[21] Ibid.
[22] IPO data obtained from Bloomberg. Only IPOs with offer stage classified as 'trading' included. Year of IPO based on 'Effective Date.'
[23] Size thresholds deflated annually at the 1 July CPI in the given year. CPI used is the Consumer Price Index for All Urban Consumers: All items from the Federal Reserve Bank of St Louis (FRED) database.



Source: Bloomberg, Federal Reserve Economic Data

The most notable trend that emerges from this analysis is the precipitous drop in the number of small IPOs since the year 2000. The number of small IPOs averaged 401 annually in the 1990s, but then dropped to only 105 annually in the 18 years since. In the 1990s, small IPOs made up 27% of all capital raised in public markets, whereas in the period from 2000 to present they have represented only 7% of all capital raised.

The trends in medium and large-cap IPOs differ significantly from those seen for smaller IPOs. For medium-sized IPOs (between $100 million and $500 million), both the number of IPOs and the amounts raised appear to be cyclical. We see downturns in the number of medium-sized IPOs in the aftermaths of the dot-com bust (2001–03) and the Great Recession (2008–09). But apart from cyclicality, there does not appear to be a significant increase or decrease in the number of medium-sized IPOs over time. The trends in large-cap IPOs present a different picture. First, there are relatively few large-cap IPOs, never more than 50 in any one year. So a few major IPOs can skew the results in terms of amounts raised. Notably, this segment was smaller in the 1990s and saw major growth in the 2000s, peaking in 2007. This segment recovered again in the years after the financial crisis, peaking in 2013, before falling through 2016. This number ticked up again in 2017 with 16 offerings, supported by major IPOs such as Snap and six major energy-sector IPOs. As we'll discuss later in this paper, the burden of regulatory pressures faced by companies in this large-cap category is very different from those affecting sub-$100 million market-capitalization companies.

4. Drivers Behind the Decline in Small-Cap IPOs

The decline in small-cap IPOs in the U.S. has been dramatic and long term. As SEC Commissioner Michael Piwowar said in his opening remarks at an SEC-New York University conference on IPOs in May 2017: "Traditional economic factors, such as fluctuations in companies' demand for capital and changes in investor sentiment, cannot explain the large decrease." Piwowar focused on a single metric to explain the overall decline. "The substantial drop in the number of IPOs in the United States is primarily driven by the disappearance of small IPOs," he said. Our segmented IPO analysis above confirms and illustrates Piwowar's statement.

A survey of the literature and of the data suggests there are five major, intertwined drivers behind the decline of small-cap IPOs: (1) analyst coverage trends, (2) buy-side trends, (3) a shift from active to passive investment strategies, (4) the growth in private capital and (5) increasingly burdensome regulation.

A. Sell-Side Coverage Trends

The issuer's decision to undergo an IPO does not occur spontaneously. Managers of companies evaluating whether to go public or not weigh numerous considerations, primarily the extent to which there will be investors on the buy side for the newly public company. If investment demand is too low, the IPO could fail or the company's share price could drop dramatically after going public. Both are disastrous outcomes for a growing company.

One important consideration management and boards make before deciding to go public is how much analyst coverage the company will receive. In fact, the necessity to attract "coverage" by analysts has traditionally been one of the key hurdles for private companies considering going public.[24] Less coverage means a smaller pool of investors will assess the stock, both in the lead-up to the IPO and in the secondary market. Research by Merkley, Michaely and Pacelli shows that the quality of analyst coverage available for a stock, as measured through forecast errors and optimism bias, is correlated with the number of analysts covering the stock.[25] They hypothesize that higher levels of competition between analysts lead to higher-quality coverage, and vice versa. This suggests that lower levels of analyst coverage should increase the wariness of potential investors that the available coverage may be of lower quality and potentially biased. This in turn can become a self-fulfilling prophecy, where low levels of coverage lead to lower investor appetite.

Why would smaller IPOs, in particular, appear to be endangered? Part of the answer may lie in the relationship between Wall Street—that is, the sell side—and investors on the buy side. Both sell side and buy side have been changing in fundamental ways since 2000—trends that affect all IPOs—but small-cap offerings most dramatically.

Since the 1970s, the sell side, roughly synonymous with investment banking and brokerage, has changed considerably. Investment banks have consolidated from a large number of small firms, many of them private partnerships, to a much more compact group of very large public corporations—including a few full-service, global banks. As firms grew larger, small-cap companies declined in importance. And the large investment banks that continue to raise equity capital need to sell clients multiple products, from M&A to debt to equity, to generate significant returns.[26] A single equity offering by a small company represents a less important, increasingly small-value client, with low potential for follow-up business. (One exception for both the sell side and buy side: biotechnology and life sciences IPOs, which may involve small caps but which are heavy capital users, offering multiple opportunities to invest in finances and the possibility of five to 10 times returns.[27])

On top of that, the mutuality of interests between investment banks' research analysts and IPO issuers spawned a sense of conflict, which emerged after the 2000 dot-com collapse. Analysts were charged with trading positive coverage for a piece of the IPO underwriting by their firm's investment bank. New York Attorney General Eliot Spitzer's crusade against research conflicts in the early 2000s led to the Global

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[24] Aggarwal, Rajesh, Laurie Krigman, and Kent Womack. "Strategic IPO Underpricing, Information Momentum, and Lockup Expiration Selling." Journal of Financial Economics 66, no. 1 (2002): 105–37.

[25] Merkley, Kenneth, Michaely, Roni, and Pacelli, Joseph, "Does the Scope of the Sell-Side Analyst Industry Matter? An Examination of Bias, Accuracy and Information Content of Analyst Reports," SSRN, Dec. 19, 2013.

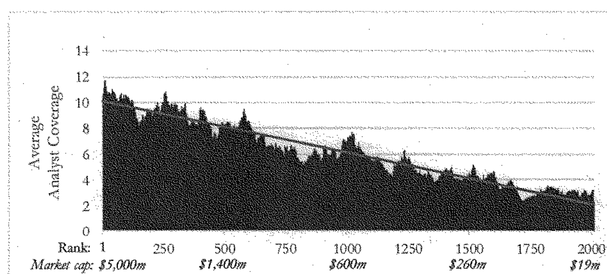
[26] Solomon, Jack, "Capital Formation, Smaller Companies and the Declining Number of Initial Public Offerings," *SEC Advisory Committee*, June 22, 2017, p. 11.

[27] Ibid. p. 8.

Analyst Research Settlements in April 2003 that banned any quid pro quo between research and investment banking[28]—meaning the promise of future business for a recommendation. While this eliminated a conflict, it undermined the economics of equity research, forcing a restructuring and rethinking of many research units. The settlement set off a chain of consequences. Investment banks had generally subsidized small-cap coverage with profits from large-cap stocks. Now the economic model of most investment banks focused more tightly on large-cap companies.[29] Smaller companies found themselves in the cold.

To assess the relationship of IPO trends and analyst coverage, we examined how levels of analyst coverage vary with market size. First, we analyzed trends in coverage among small-cap stocks, starting by looking at the constituents of the Russell 2000. This index takes the smallest 2,000 companies of the Russell 3000 index, which itself is made up of the largest 3,000 publicly listed companies in the U.S. and is intended to be a benchmark for the entire stock market. Ranking the constituents of the Russell 2000 in decreasing order of market capitalization, we found that the level of analyst coverage for each stock decreases in line with size. The largest company in the index has a market capitalization of about $5 billion and is covered by 15 sell-side analysts, while the smallest has a market capitalization of $19 million and is covered by four analysts.[30] To reduce volatility in the data and better illustrate this trend of declining coverage with market value, we calculated the average level of coverage based on the 25 closest ranked stocks to each side of the relevant company (to calculate an average of 51 data points). We show the raw data in Appendix Item 2. Our analysis neatly shows the trend: The average level of coverage decreases from around 10 analysts for the largest companies in the index to just two analysts for the smallest companies. This is shown by the linear trend line in the data below.

Figure 4: Russell 2000—Analyst coverage declines in line with a company's market value.



Source: Russell, Bloomberg

The low levels of coverage for smaller stocks are significant. With coverage from just a few analysts, companies find it exceedingly difficult to attract new investors or to raise additional capital. We note that 159 companies in the Russell 2000 had no coverage at all. With such thin coverage, investors seeking to perform due diligence on a potential investment are unable to obtain a diversity of opinions about the stock.

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[28] "SEC Fact Sheet on Global Analyst Research Settlements." U.S. Securities and Exchange Commission. Accessed December 18, 2017. https://www.sec.gov/news/speech/factsheet.htm.

[29] Solomon, op. cit., p. 15.

[30] Factset as at 30 June 2017.

This inability to perform a "broker consensus" is likely to preclude investors from investing in the company, particularly in light of the findings of Merkley, Michaely and Pacelli, described above, which suggest that lower levels of coverage equate to lower-quality coverage.[31]

This problem is particularly pronounced for the smallest companies. Research from Cowen shows that over 60% of the 1,171 companies with market capitalization below $100 million listed on major U.S. exchanges receive no analyst coverage.[32] This research suggests that a lack of coverage corresponds with lower stock liquidity and is particularly a problem for retail investors with limited research capabilities.

B. Buy-Side Investing Trends

Another longer-term trend in the years after 2000 reshaped the buy side. The result was similar to the sell side: Larger entities lost interest in relatively smaller companies. The universe of investors that buys stocks and "pays" for sell-side research, either through brokerage stock commissions or so-called soft dollars (which trade research for commissions without cash changing hands) has significantly changed. The equity markets began experiencing a broad shift from small retail investors to large institutional investors starting in the 1960s.[33] Over the decades, those institutions grew larger, meaning that smaller-cap IPOs had less impact on their returns.[34] As a result, institutions like investment banks gravitated toward liquid, large-cap stocks that could produce higher absolute-dollar returns.[35]

Meanwhile, the composition of investors in IPOs changed. Even as late as the dot-com boom, many IPOs had a substantial component of retail investors.[36] But during this period, a fundamental shift in investing began to occur. Retail brokerage as a profit engine had been in decline since commissions were deregulated in 1975, and price competition ensued. Meanwhile, more and more retail investment was going into self-directed retirement plans, like individual retirement accounts or 401(k)s, essentially redirected to institutions.[37] These vehicles invested in stocks, but not necessarily in IPOs.

To large institutions managing equity portfolios in the billions of dollars, stocks below a certain market capitalization were simply too small to "move the needle."[38] Investment funds typically seek to take positions in portfolio companies valued in the millions of dollars. For a small-cap stock with a market capitalization of less than a few hundred million dollars, such a position will present a material ownership

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[31] Merkley, Michaely and Pacelli. op. cit.
[32] Solomon, op. cit., p. 14.
[33] Western, David L. "Booms, Bubbles and Busts in the US Stock Market." Psychology Press, 2004.
[34] Goldstein, Michael, Paul Irvine, Eugene Kandel, and Zvi Wiener. "Brokerage Commissions and Institutional Trading Patterns." The Society for Financial Studies, October 24, 2009. https://pdfs.semanticscholar.org/a97f/162148741f78c4a63d17885e2bd33de19cfd.pdf.
[35] Solomon, op. cit., p. 5.
[36] Langevoort, Donald. "The SEC, Retail Investors, and the Institutionalization of the Securities Markets." Georgetown University Law Center, 2008. http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1082&context=fwps_papers.
[37] Ibid.
[38] Ranguelova, Elena, Jonathan Feeney, and Yi Lu. "Under the Radar: Structural Alpha in the Small-Cap Equity Market." New York, NY: Investcorp, July 2015. http://www.investcorp.com/docs/uploads/credit-ratings/Under_the_Radar_Structural_Alpha_in_the_Sm-Cap_Equity_Market_201507_F.pdf.

stake in the company and may require disclosure in order to meet regulatory requirements.[39] In addition, thinly traded stocks tend to have wider bid-ask spreads, meaning the transaction costs associated with taking positions (and later exiting them) are larger. Researchers have found that this illiquidity of small stocks has driven large investment funds from them since the late 1990s. For example, Bartlett, Rose and Solomon have argued that the market events surrounding the Russian financial crisis of 1998 "prompted a fundamental reconsideration among mutual-fund portfolio managers about the liquidity risk of investing in small IPOs."[40] They argue that this led to a sustained change in the investment paradigms of major institutional investors.

Gao, Ritter and Zhu make a different argument. They believe that "an ongoing change in the economy" has led to a situation where small companies have suffered a broad decline in profitability, particularly because of the acceleration of technology.[41] As a result, managers at those companies feel they can create greater profits by selling out in a trade sale to a larger company in or around their industry than by operating independently and growing organically. In particular, they feel a greater urgency to grow quickly, "with profitable growth opportunities potentially lost if they are not quickly seized."[42] That, they conclude, is an explanation for the decline in small IPOs.

C. The Shift from Active to Passive Investing

Another more recent phenomenon contributing to the reduction in buy-side demand for small caps is the growth of passive investing strategies at the expense of active or value investing. These low-fee portfolios that mirror the market, or aspects of it, began to grow quickly after 2000 as investors recoiled from the market shocks of the dot-com bust and the financial crisis. These passive strategies represent a fundamental shift in investing, from brokerages charging commissions and mutual funds actively trading, to low-cost fee-driven index funds pursuing essentially passive strategies. This evolution was fueled by the broad acceptance of the principle of efficient markets, which makes the case that fund managers will not consistently beat the market. In the last few years, as the recovery from the Great Recession lifted stock values, that shift has accelerated. In 2016, according to Morningstar, ownership of U.S. stocks was 46% passive and 54% active.[43] In that year, some $263 billion exited actively managed funds—mostly mutual funds—and $237 billion moved into index funds or exchange-traded funds, more than double that of 2015.[44] The bottom line for IPOs: Passive money doesn't participate in capital formation like IPOs, nor does it demand traditional equity research.

The shifting investment preferences of mutual funds and the trend toward passive investments drive a reduction in the level of demand for small caps in both primary and secondary markets.

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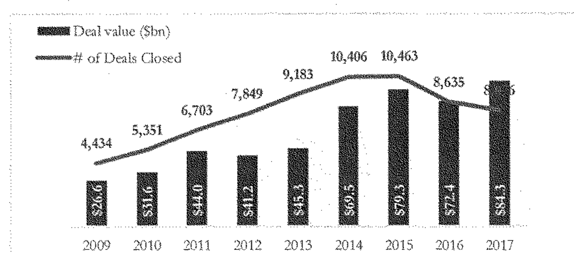
[39] "Schedule 13D." U.S. Securities and Exchange Commission, accessed December 18, 2017. https://www.sec.gov/fast-answers/answerssched13htm.html.
[40] Bartlett, Robert P. III, Rose, Paul, and Solomon, Steven Davidoff, "The Small IPO and the Investing Preferences of Mutual Funds," SSRN, 2017, p. 2.
[41] Gao, Xiaohui, Ritter, Jay, and Zhu, Zhongyan, "Where Have All the IPOs Gone?" SSRN, Aug. 26, 2013.
[42] Ibid. p. 4.
[43] Solomon, op. cit. p. 7.
[44] Ibid. p. 7.

D. Growth in Private Capital

As regulatory and organic market factors have reduced the appeal of public listings for small caps, a key alternative, raising capital privately, has become more accessible. Citing Preqin data, the Boston Consulting Group reports that the total assets under management of the world's private equity firms have increased from $1.8 trillion to $2.5 trillion in the past five years, an increase of 39%.[45] This growth is being similarly reflected in venture capital funds. Data from the National Venture Capital Association (shown below) indicates that VC funding in the U.S. has more than doubled over the past five years.[46] There is no stronger symbol of this growth than SoftBank's unprecedented circa $100 billion Vision Fund, closed in 2017.[47] Of course, growth in funds targeting VC investment does not in itself prove that private funding is displacing small-cap IPOs, but it may indicate the increasing viability of this alternative for small caps looking to raise capital.

Figure 5: US VC Activity: more funding is chasing fewer VC deals.



Source: National Venture Capital Association

John Coffee, a professor at Columbia Law School, has argued that the decline in IPOs coincided with the liberalization of rules on private placements. He noted that the Rule 144 amendment in 1990, aimed at creating greater liquidity, "meant that large institutional investors (known as Qualified Institutional Buyers) could quickly resell privately placed securities of smaller non-reporting issuers to each other."[48] In 1997, the SEC relaxed rules on the resale of privately placed securities, reducing the mandatory post-placement holding period to one year (from two years). Coffee also added that the development of alternative trading systems (ATSs) for privately placed stock, pioneered by firms such as SecondMarket

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[45] Hammoud, Tawfik, Michael Brigl, Johan Oberg, David Brostein and Christy Carter. Capitalizing on the New Golden Age of Private Equity. Boston Consulting Group. March 2017.

[46] "Venture Monitor 4Q 2017." Washington, DC: Pitchbook and National Venture Capital Association, 2018. https://nvca.org/research/venture-monitor/.

[47] "Establishment of SoftBank Vision Fund | Press Releases | News | About Us." SoftBank Group. Accessed January 30, 2018. https://www.softbank.jp/en/corp/news/press/sb/2016/20161014_02/.

[48] Coffee, John, "Gone With the Wind: Small IPOs, the JOBS Act, and Reality," CLS Blue Sky Blog, http://clsbluesky.law.columbia.edu/2013/02/01/gone-with-the-wind-small-ipos-the-jobs-act-and-reality/, Feb. 1, 2013.

(since acquired by Nasdaq), "has further reduced the pressure on issuers to conduct an early IPO."[49] It is now easier for growing companies to obtain the capital they need while staying private.

Other regulatory actions have streamlined requirements for offerings in private markets, making this process easier for issuers. The most significant step forward with respect to private offerings was the National Securities Markets Improvement Act of 1996 (NSMIA), which exempted covered securities—companies registered with or otherwise exempted by the SEC—from having to comply with registration and review requirements in each state where they intended to offer securities.[50] This substantially simplified and standardized the offering process for companies, allowing them to preempt so-called blue-sky laws and more easily undertake offerings across multiple states.

In the years following the NSMIA, the growth of the internet dramatically disrupted the traditional offering process. By connecting potential issuers and investors, the internet diminished the relative power of centralized stock exchanges, which had historically provided a physical marketplace for shares. In the years that followed, private companies have been able to list on alternative trading systems that function much like traditional public equity markets, effectively blurring the line between public and private ownership. As noted by Ewens and Farre-Mensa, the internet has lowered search costs and substantially enhanced the ability of companies to meet their capital needs while remaining private. [51]

While it is commonly known for its reforms aimed at stimulating public equity offerings, the JOBS Act also introduced concessions for certain types of private offerings. Title IV of the legislation increased the amount that a company can raise under a Regulation A offering from $5 million to $50 million. This is significant since these offerings are exempt from requiring registration and are open to non-accredited as well as accredited investors.[52] In addition, the bill created a new form of Regulation D offering that allows general solicitation of investors, provided that only accredited investors participate in the offering.[53] As stated by the SEC, this allowance for general solicitation reversed "almost 80 years of regulatory practice."[54] These reforms make small private capital offerings easier to undertake.

In fact, empirically, the most potent form of private capital for startups appears to be venture capital. Although VC comprises less than 1% of startup funding,[55] research suggests that venture-backed

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49 Ibid.

50 "National Securities Markets Improvement Act of 1996," October 11, 1996. https://www.gpo.gov/fdsys/pkg/PLAW-104publ290/pdf/PLAW-104publ290.pdf.

51 Ewens, Michael, and Joan Farre-Mensa. "The Evolution of the Private Equity Market and the Decline in IPOs." SSRN Scholarly Paper. Rochester, NY: Social Science Research Network, Dec. 3, 2017. https://papers.ssrn.com/abstract=3017610.

52 "SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital." U.S. Securities and Exchange Commission. Accessed Dec. 18, 2017. https://www.sec.gov/news/pressrelease/2015-49.html.

53 Ibid.

54 Bauguess, Scott, Rachita Gullapalli, and Vladimir Ivanov. "Capital Raising in the US: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014." U.S. Securities and Exchange Commission, October 2015. https://www.sec.gov/files/unregistered-offering10-2015.pdf.

55 Da Rin, Marco, Thomas F. Hellmann, and Manju Puri. "A Survey of Venture Capital Research." Working Paper. National Bureau of Economic Research, October 2011. http://www.nber.org/papers/w17523.

companies play an outsized role in job creation,[56] IPOs[57] and innovation.[58] Traditionally, VC funding was consigned to the earliest and riskiest stages of new company development. As a result, venture portfolios have long accepted the reality of many failures, a smaller number of reasonably successful companies and a handful of blockbusters. Quite a lot of research suggests that venture funding offers significant advantages to companies over other forms of financing: their sales[59] and employees[60] grow faster, their professionalism is greater,[61] time to market is shorter,[62] the likelihood of an IPO is greater[63] and post-IPO survival is longer.[64]

Ewens and Farre-Mensa argue that "private markets are filling much—if not all—of the IPO gap."[65] Relying on Dow Jones VentureSource data on VC-backed startups, they argue that "of those startups whose first round was before 1997 and went on to raise over $150 million in the following seven years, 83% did so by going public; by contrast, only 36% of startups reaching that scale since 2000 were public—even though the annual number of startups raising over $150 million has not changed." This suggests that startups are opting to remain private. We do note that this data may suffer from selection bias, given that VC-backed startups (which, by definition, have a history of private investment) are more likely to be able to access private capital markets than non-VC-backed firms. So the trend of VC-backed startups remaining private may not necessarily be reflected by all startups.

To attempt to identify trends in the broader market for private capital offerings, we analyzed data from the SEC's Electronic Data Gathering, Analysis and Retrieval (EDGAR) system. If the hypotheses of researchers such as Ewens and Farre-Mensa is correct, we would expect to see an uptick in the number of private capital offerings. First, we needed to confirm where exactly to look. There are many challenges in analyzing SEC data. There are multiple types of private offerings, including 144As, Regulation D, Regulation A and Regulation S. We narrowed our analysis to the Regulation D market for the following reasons. While the 144A market is of significant size, "over 99% of securities" in it are debt instruments, which are not comparable to IPOs.[66] Data is also not available for the small number of 144A equity offerings. In 2014, the average Reg D offering raised around $39 million.[67] While the Reg D market is "mainly equity offerings,"

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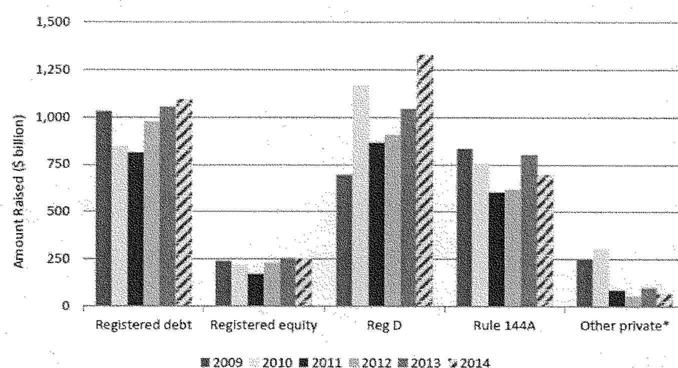
[56] Puri, Manju, and Rebecca Zarutskie. "On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms," working paper, National Bureau of Economic Research, August 2008. http://www.nber.org/papers/w14250.
[57] Da Rin. op. cit.
[58] Kortum, Samuel, and Josh Lerner. "Assessing the Contribution of Venture Capital to Innovation." The RAND Journal of Economics 31, No. 4 (2000): 674–92. https://doi.org/10.2307/2696354.
[59] Tyebjee, Tyzoon T., and Albert V. Bruno. "A Model of Venture Capitalist Investment Activity," Management Science 30, No. 9 (Sep. 1, 1984): 1051–66. https://doi.org/10.1287/mnsc.30.9.1051.
[60] Davila, Antonio, George Foster and Mahendra Gupta, "Venture-Capital Financing and the Growth of Startup Firms." Stanford Graduate School of Business, 2000, https://www.gsb.stanford.edu/faculty-research/working-papers/venture-capital-financing-growth-startup-firms.
[61] Hellmann, Thomas, and Manju Puri. "Venture Capital and the Professionalization of Startup Firms: Empirical Evidence." The Journal of Finance 57, No. 1 (Feb. 1, 2002): 169–97. https://doi.org/10.1111/1540-6261.00419.
[62] Ibid.
[63] Shane, Scott, and Toby Stuart. "Organizational Endowments and the Performance of University Startups." Management Science 48, No. 1 (Jan. 1, 2002): 154–70. https://doi.org/10.1287/mnsc.48.1.154.14280.
[64] Baker, Malcolm, and Paul Gompers. "The Determinants of Board Structure at the Initial Public Offering," SSRN Scholarly Paper. Rochester, N.Y.: SSRN, Aug. 1, 2002. https://papers.ssrn.com/abstract=236035.
[65] Ewens, Michael, and Joan Farre-Mensa, op. cit.
[66] Ibid.
[67] Bauguess, op. cit.

the SEC has reported that from 2009–14, 13.2% of Reg D offerings were debt offerings.[68] Reg D is also used for more customized kinds of offerings, such as those including options or warrants.[69] Unfortunately, the available Reg D data does not allow us to separate out debt and other offering types. Relevant amounts raised in the key capital markets are shown in the chart below for the period 2009–14 from the SEC.

Figure 6: Aggregate capital raised by offering method, 2009–14



* Other private includes Regulation S offerings, Section 4(a)(2) offerings, and Regulation A offerings.

Source: SEC

Filtering Reg D data in order to identify those private offerings where the company's management may also have undertaken making an offering on public markets, we find evidence that suggests that private capital may be filling the IPO gap. The data, shown below, comes from Form D documents that companies file with the SEC on undertaking a private offering. This Form D documentation is only available in electronic form from 2009 onward. Taking the Form D data, we removed the offerings attributable to investment companies raising new capital for new investment funds. These issuers make up the majority of Reg D offerings but do not represent potential IPO candidates. These are undertaken by "hedge funds, venture capital funds, private equity funds and other pooled investment funds" and made up 84% of all capital raised through Reg D offerings from 2009–14.[70] We isolated the non-fund Reg D offerings and additionally removed offerings of under $1 million. We did see that the number of non-fund Reg D offerings greater than $1 million has been growing consistently in the period since 2009. This growing source of funding may be absorbing some or many would-be IPOs.

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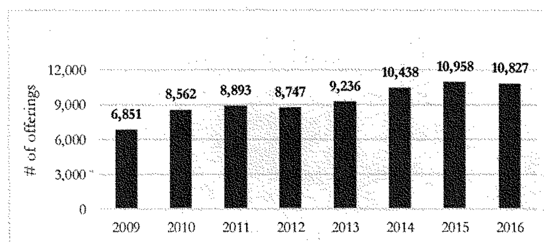
[68] Ibid.
[69] Ibid.
[70] Bauguess, op. cit.

Figure 7: Non-fund Regulation D offerings raising greater than $1 million



Source: SEC

Our analysis suggests that private capital markets may be substituting for public markets, which have historically been a larger source of capital for small-cap companies. This has been assisted by regulatory changes that have made private capital offerings easier and accentuated a preference of companies to remain private. Elisabeth de Fontenay, an associate professor at Duke University School of Law, notes a structural advantage held by private companies: "Private companies today can raise large amounts of capital while disclosing less than their public company counterparts in part by free riding on the enormous volume of public-side information, which makes private company valuation vastly easier and more accurate."[71] Some of these disclosure requirements for public companies are discussed in the next section.

E. Regulatory Pressures

The decline in IPOs after 2000 coincided with a period of increasing regulatory restrictions for listed companies. Regulatory efforts such as Regulation Fair Disclosure (2000), Sarbanes-Oxley (2003) and Dodd-Frank (2010) represented changes in how and what information was disclosed to investors and materially increased the potential liability faced by company directors. The accumulating layers of regulation that they represent has contributed to the belief that more companies delay or decline IPOs because of the mounting regulatory burden of public ownership. That regulation, plus changes in the marketplace like rising levels of M&A, ubiquitous activist investors and the demands of "short-termism" in a shareholder-centric system, has also contributed to the appeal of remaining private. While regulation has clearly played a role in avoiding IPOs, the subject is not at all straightforward.

In October 2000, the SEC implemented Regulation Fair Disclosure, or Reg FD. This rule demanded that if or when a listed company "discloses material nonpublic information ... it must make public disclosure of that information."[72] This was intended to stamp out selective disclosure of information by

[71] De Fontenay, Elisabeth, "The Deregulation of Private Capital and the Decline of the Public Company," Harvard Law School Forum on Corporate Governance and Financial Regulation, April 27, 2017. https://corpgov.law.harvard.edu/2017/04/27/the-deregulation-of-private-capital-and-the-decline-of-the-public-company/.

[72] "Final Rule: Selective Disclosure and Insider Trading." U.S. Securities and Exchange Commission, August 21, 2000. https://www.sec.gov/rules/final/33-7881.htm.

companies prior to public release, particularly to analysts or institutional investors. While the costs of complying with this requirement are theoretically low, it opened up major potential liabilities for public companies. Reg FD also introduced a degree of ambiguity into decision making. Indeed, what is or is not considered material nonpublic information may be subject to reasonable debate. And even if the distinction is clear, Reg FD necessitates that management be prepared to publicly release such information "as soon as is reasonably practicable," if for some reason it is unintentionally disclosed.[73]

Enacted in response to scandals such as Enron and WorldCom, Sarbanes-Oxley introduced a number of requirements relating to internal controls, auditing and financial disclosure. The act required that the chief executive officer or the chief financial officer certify corporate financial statements, and established criminal penalties for knowingly certifying noncompliant reporting. The most contentious of these regulations for smaller companies is Section 404, the Assessment of Internal Controls, which under part (a) requires that management report on the effectiveness of its internal controls over financial reporting and under part (b) requires that this report be attested to by an external auditor.[74] Concerns about the impact of this requirement on small companies prompted the SEC in 2005 to charter a 21-member Advisory Committee on Smaller Public Companies to evaluate the issue.[75]

Reporting in 2006, the committee found that smaller public companies "have been disproportionately subject to the burdens associated with Section 404 compliance." [76] They reported that for companies with market capitalizations of less than $100 million, Section 404 compliance costs on average amounted to 2.55% of total revenue.[77] This compared to a figure of 0.53% for companies with market capitalizations of $100 million to $499 million. The figure was lower again for even larger companies. Based on its analysis, the committee recommended that companies with market capitalizations below $128 million be exempted from Section 404 "unless and until a framework for assessing internal controls over financial reporting for such companies is developed that recognizes their characteristics and needs.[78]

After years of SEC deferrals in enacting elements of Sarbanes-Oxley, including Sections 404(a) and (b), Dodd-Frank gave a permanent exemption from Section 404(b) to companies classified as non-accelerated filers. As per Rule 12b-2 of the Securities Exchange Act,[79] non-accelerated filers are companies with common equity held by non-affiliates valued at less than $75 million. This threshold, which has not changed since Dodd-Frank was passed, is substantially below the $128 million benchmark in the SEC's advisory committee report in 2006. We note that if adjusted for inflation, this $128 million benchmark would be $154 million in 2017 dollars.[80] This suggests there is scope for the threshold under which the exemption applies to be raised.

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[73] Ibid.
[74] "15 U.S. Code § 7262 - Management Assessment of Internal Controls." Legal Information Institute, accessed Dec. 18, 2017, https://www.law.cornell.edu/uscode/text/15/7262.
[75] "Final Report of the Advisory Committee on Smaller Public Companies." U.S. Securities and Exchange Commission, April 23, 2006, https://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf, p. 1.
[76] Ibid. p. 23.
[77] Ibid. p. 33.
[78] Ibid. p. 6.
[79] "17 CFR 240.12b-2 - Definitions." Accelerated filer and large accelerated filer. Legal Information Institute, accessed December 18, 2017, https://www.law.cornell.edu/cfr/text/17/240.12b-2.
[80] Based on Consumer Price Index for All Urban Consumers: All Items from the Federal Reserve Bank of St. Louis (FRED) database, https://fred.stlouisfed.org/series/CPIAUCSL?cid=9

Other regulatory actions in the early to mid-2000s may have dampened investor appetite for small-cap stocks. As already mentioned, the Global Analyst Research Settlement increased the compliance burden on investment banks providing sell-side coverage of stocks, making research a less attractive business, and likely exacerbated low levels of coverage on small-cap stocks. At the same time, the introduction of the Regulation National Market System (Reg NMS) by the SEC in 2005 reduced the liquidity of small-cap stocks. By making securities tradable across multiple exchanges, the already small number of daily transactions for small stocks has been distributed across multiple markets, lowering liquidity.[81] All else being equal, this increases the return required from an investment in order to overcome transaction costs associated with larger bid-ask spreads.

In addition to its focus on the banking system, Dodd-Frank introduced new requirements relating to company disclosures. These included sections relating to conflict minerals (Section 1502), mine safety (Section 1503), resource extraction (Section 1504) and pay ratio (Section 953[b]). In their 2017 report on capital markets, the Treasury argued that while the inclusion of certain of these provisions was well intentioned, "the effort to use securities disclosure to advance policy goals distracts from their purpose of providing effective disclosure to investors."[82] We agree that if the intention is to affect the conduct of companies with regard to specific policy matters, these aims will be better achieved by policy enacted through the relevant department of government in the specific policy area. However, if disclosures are viewed as material, their inclusion may be justified. In the context of an increasing focus on ethical investment and the screening of potential investments based on environmental, social and governance (ESG) factors, defining what information is material is increasingly challenging. Ultimately, any disclosure requirements must take into account a certain level of practicability in terms of the ability of the company to obtain the necessary information weighed against its importance.

In the aftermath of the financial crisis, the JOBS Act (2012) attempted to promote capital formation in both public and private markets. Title I of the bill defined a new class of publicly listed companies that would receive regulatory exemptions through and after the IPO process, so-called emerging growth companies (EGCs). In accordance with the act, a company will be classified as an EGC if it listed after December 9, 2011, and:

- Is not a large accelerated filer (that is, has free float of less than $700 million).
- Has gross annual revenues of under $1 billion.
- Has issued less than $1 billion in non-convertible debt in the prior three-year period.
- Has been listed for less than five years.

The act allows EGCs to receive certain benefits in the listing process and in the secondary market. These include the ability to confidentially share draft IPO material with the SEC, to sound out potential investor demand by "testing the waters," and to face fewer restrictions with regard to the distribution of analyst research.[83] EGCs are also only required to present two (rather than three) years of audited financial statements. Post-IPO, EGCs are exempt from certain disclosure requirements, such as on CEO pay-ratio and auditor attestation of internal controls (as per Sarbanes-Oxley Section 404[b]).[84] These provisions are

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[81] U.S. Department of Treasury. op. cit. p. 60.
[82] U.S. Department of Treasury, op. cit. p. 29.
[83] "Jumpstart Our Business Startups Act, Frequently Asked Questions." U.S. Securities and Exchange Commission, Dec. 21, 2015. https://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.
[84] "Update on Emerging Growth Companies and the JOBS Act," Ernst & Young LLP, November 2016. http://www.ey.com/Publication/vwLUAssets/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016/$FILE/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016.pdf.

clearly beneficial to companies evaluating a potential listing. Since the JOBS Act was implemented, 87% of IPOs have been EGCs.[85]

One provision of the JOBS Act was that the SEC should study and issue a report on the decimalization of equity trading that officially began in 2001, after years of debate and experimentation. Decimalization priced trading to the penny rather than in fractions, in large part to reduce bid-ask spreads. In 2011 the Treasury sponsored a conference and formed an IPO Task Force to "examine the challenges that emerging-growth companies face in pursuing an IPO" and develop recommendations.[86] A year later, the SEC staff published a report that summarized its findings. Decimalization, the report argued, kicked off changes in market structure toward "a low-cost, frictionless environment characterized by electronic trading that favored highly liquid, large capitalization stocks at the expense of smaller capitalization stocks."[87] The changes favored short-term strategies and particularly hurt less liquid smaller companies with trading volumes too low "to make money for the investment bank's trading desk."[88] The task force concluded "that the lack of profitability undermines the incentives for underwriters to take smaller companies public."[89]

The report also noted that decimalization threatened "the economic sustainability of sell-side research departments" by reducing spreads and trading commissions that once supported research. The combination of the Global Analyst Research Settlement and decimalization made analyst coverage of small companies unprofitable.[90]

The Task Force did ultimately conclude that the benefits of decimalization outweighed the costs, arguing that the public has gained from greater market access and reduced trading costs.[91] But the report made clear that small-company IPOs had been affected by fundamental changes in market structure.

5. Policy Recommendations

Our analysis suggests that the decline in small-cap IPOs cannot be explained by any one factor alone. The decline has been the result of a combination of natural market trends and regulatory pressures. In evaluating potential regulatory reform, the relevant question to ask is: To what extent has each factor played a part? Some of the factors, such as shifts in investing preferences from active to passive funds, are difficult to address through reforms to legislation or enforcement approaches. However, regulatory reforms have the potential to make IPOs relatively more appealing when they are weighed against other options that may be contemplated by companies considering a listing.

We posit that the regulatory reforms of the early 2000s (including Reg FD and Sarbanes-Oxley) have contributed to the wariness companies have shown in undertaking IPOs. This is driven by the perceived negative impacts of being listed on public markets, which include myriad reporting and disclosure

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[85] Ibid.
[86] Securities and Exchange Commission, "Report to Congress on Decimalization," July 2012, https://www.sec.gov/news/studies/2012/decimalization-072012.pdf, p. 1.
[87] Ibid. p. 2.
[88] Ibid. p. 2.
[89] Ibid. p. 2.
[90] Ibid. p. 2.
[91] Ibid. p. 2. footnote 7.

requirements, exposure to personal liability and the transfer of some level of corporate control to public shareholders. Reforms that can reduce concern around these factors would make IPOs more appealing relative to the other options available. We therefore propose the following recommendations.

A. Increase the Threshold for Eligibility as a Smaller-Reporting Company (SRC) and Non-Accelerated Filer

The first part of this recommendation is already under way. In June 2016, the SEC proposed to amend the definition of SRC to increase the ceiling for inclusion from $75 million to $250 million in free float.[92] This proposal is in the "final rule stage" as of February 2018.[93] According to the SEC, this amendment would lead to an increase in the number of SRCs from around 32% to 42% of all listed companies.[94] Companies that would become SRCs as a result of the change would be freed from various financial and management reporting requirements. These include concessions relating to management discussion and analysis in annual reports and the level of required detail on executive compensation and historical financial statements.[95]

Despite pursuing this positive change, the SEC has not proposed to similarly update the definitions related to accelerated filing, meaning that companies recategorized as SRCs under the amendment would remain accelerated filers.[96] This is relevant given that the definitions of SRC and non-accelerated filer are currently aligned, meaning that any company that is an SRC is also a non-accelerated filer. Under the proposed rule change, companies with free float between $75 million and $250 million will have their status updated to that of SRC, but will remain accelerated filers. This means they would still be required not only to report Forms 10Q and 10K in 40 and 75 days, respectively (faster than for SRCs), but also to comply with SOX Section 404(b) (auditor attestation of internal controls). As discussed in Section 4, Section 404 compliance is a major cost for small companies.

Aligning the definition of non-accelerated filer with the forthcoming updated definition of SRC will streamline the regulatory categories and provide relief to small-cap companies with free float between $75 million and $250 million. We note that this recommendation was put forward by the CEO of Sutro Biopharma, a private biopharmaceutical company headquartered in San Francisco, at the September meeting of the SEC Advisory Committee on Small and Emerging Companies.[97]

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[92] "SEC Proposes Amendments to Smaller Reporting Company Definition." U.S. Securities and Exchange Commission, June 27, 2016. https://www.sec.gov/news/pressrelease/2016-131.html.
[93] "View Rule, RIN: 3235-AL90." Reginfo.gov. Office of Information and Regulatory Affairs. Accessed February 13, 2018. https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201710&RIN=3235-AL90.
[94] "Proposed Rule: Amendments to Smaller Reporting Company Definition." U.S. Securities and Exchange Commission, June 27, 2016. https://www.sec.gov/rules/proposed/2016/33-10107.pdf, p. 18.
[95] Ibid. pps. 8-9.
[96] "Fast Answers: Form 10-Q." U.S. Securities and Exchange Commission. Accessed Dec. 19, 2017. https://www.sec.gov/fast-answers/answersform10qhtm.html.
[97] Newell, William, "Sarbanes-Oxley Section 404(b): Costs of Compliance and Proposed Reforms," presented at the SEC Advisory Committee on Small and Emerging Companies, Sep. 13, 2017. https://www.sec.gov/info/smallbus/acsec/william-newell-acsec-091317.pdf.

B. Extend the EGC On-Ramp

Since the JOBS Act was enacted in April 2012, 87% of all IPOs have self-identified as EGCs.[98] This high percentage suggests that most companies undergoing listings find the concessions offered to EGCs to be desirable. At present, a company can remain an EGC for five years post-listing, provided that its revenues remain below $1 billion, public float remains below $700 million and it does not raise more than $1 billion in debt over a three-year period.[99]

It is understandable that once companies surpass a certain size threshold, they should be expected to abide by stricter reporting and disclosure requirements, which reflect the demands of their diversified investor bases. Also, once above a certain size, the proportional cost of meeting these requirements is less. However, what if a company reaches the end of the five-year on-ramp and has not surpassed any of these size thresholds? The five-year timeline appears to assume that a company will grow above the EGC size thresholds over that time. This, of course, may not be the case. The cessation of the concessions afforded to the company as an EGC will create a substantial burden for a company that has not achieved scale.

So it must be asked what the purpose of the five-year timeline actually is, other than a reflection of an expectation as to how long it will take a company to achieve a certain scale. For a small company considering an IPO, the EGC concessions would be substantially more compelling if they were offered without a timeline. After all, it is the size that is most relevant to the relative cost of compliance. While removing the on-ramp timeline altogether may not be feasible, given it would create two tiers of companies (those that went public before the JOBS Act and those after), it may be appropriate to extend the timeline. A shift to a 10-year on-ramp would provide company management substantially longer to leverage the benefits of EGC status and would enhance sentiment around IPOs.

We therefore support the extension of the time that a company may remain an EGC after an IPO. A shift to a 10-year on-ramp would give company management evaluating a potential IPO substantially more comfort around their ability to economically meet their near-term regulatory requirements upon listing.

C. Increase the Shareholding Required to Bring Shareholder Proposals

The current provisions allowing shareholders to put forward shareholder proposals at annual company meetings set the bar too low. The $2,000 shareholding amount required to be able to table proposals was instituted more than 30 years ago[100] and is not fit for the present day. While arguments can be made for the benefits of the democratization of the public markets, it is neither practical nor efficient for shareholders owning an immaterial amount of a company's stock to be able to wield a disproportionate influence on a company's affairs. For instance, the Manhattan Institute found that in 2016, one third of all shareholder proposals were brought by just six individual investors.[101] This suggests that shareholder proposals are being driven by the individuals proposing them, rather than by anything the company is or is

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[98] Ernst & Young LLP, op. cit.
[99] Ibid.
[100] U.S. Department of Treasury, op. cit. p. 32.
[101] Copland, James, and Margaret O'Keefe. "Proxy Monitor: An Annual Report on Corporate Governance and Shareholder Activism." Manhattan Institute, 2016, https://www.manhattan-institute.org/sites/default/files/pmr_2016.pdf, p. 7.

not doing. Shareholder proposals take up significant time and company resources to deal with, yet they cost almost nothing for shareholders to submit.

A balanced approach to shareholder proposals would be more appropriate. We will not suggest an optimal threshold, but the current $2,000 requirement is obviously too lenient. The shareholding value should be substantially revised upward, and the requirement should be based on the percentage ownership in the company. It is unreasonable to allow shareholders owning less than 0.001% of a company's stock to dominate shareholder meetings.

Additionally, the requirements for resubmitting proposals substantially similar to those tabled in prior years should be revised. At present, "if over a five-year period a proposal fails to receive 3% support once, 6% twice or 10% three times, a company may exclude it."[102] Notwithstanding drastic changes in the share register of a company, any proposal that receives less than 3% support on one occasion is extremely unlikely to be passed in the years following. With such low requirements, shareholder activists can waste time at company meetings year after year, with little scope or intention for a proposal to actually be passed. We believe that adopting the percentage requirements proposed by the SEC in 1997 but never enacted (6%, 15%, 30%) would be a reasonable approach.[103]

D. Allow Shareholders the Right to Mandatory Arbitration

Since 2006, the Committee on Capital Markets Regulation has urged the SEC to allow corporations to include in their charters the provision for mandatory arbitration in issuer-stockholder disputes. We agree with this step, believing it would reduce a major cost for all public corporations, and particularly for smaller companies that might be considering an IPO. Harvard Law School's Hal Scott, who directs the Committee on Capital Markets Regulation, describes the current U.S. system of securities class-action litigation as "anomalous and extreme," noting that "going public in the U.S. exposes companies to litigation risk that can cost billions of dollars—the mere filing of such suits can reduce a company's market value by 10%, and public companies have paid $55.6 billion in securities class-action settlements in the last 10 years."[104] Scott notes that investors rarely are compensated adequately themselves in these lawsuits. In 2016, plaintiff's attorneys received fully $1.27 billion in fees and expenses from such cases, out of the $6.4 billion in settlements.[105]

SEC Commissioner Michael Piwowar endorsed this approach in July 2017, soon after the agency's new chairman, Jay Clayton, suggested plans for a broad rollback of regulatory requirements on companies going public, particularly on disclosure. The issue has been controversial. Republicans and the Consumer Financial Protection Bureau (CFPB) have battled over mandatory arbitration after the CFPB adopted rules

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[102] Higgins, Keith. "Finding Common Ground on Shareholder Proposals," Oct. 3, 2017. https://corpgov.law.harvard.edu/2017/10/03/finding-common-ground-on-shareholder-proposals/.

[103] Ibid.

[104] Scott, Hal. "Shareholders Deserve Right to Choose Mandatory Arbitration." CLS Blue Sky Blog (blog), Aug. 21, 2017, http://clsbluesky.law.columbia.edu/2017/08/21/shareholders-deserve-right-to-choose-mandatory-arbitration/.

[105] Ibid.

banning banks and credit card companies from participating in class actions.[106] But we believe some restraints on shareholder litigation make sense, particularly for smaller emerging companies.

E. Simplify the Disclosure Framework

As a recent Heritage Foundation backgrounder on securities regulation, written by senior fellow David Burton, outlined, there are currently some 14 different categories of firms using securities, each with different exemption and disclosure requirements, creating different classes of investors across them.[107] These have expanded over the past few decades through legislation like SOX, Dodd-Frank and the JOBS Act. "Disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find the relevant information."[108] Throughout this paper, we have discussed a number of these categories: three tiers of crowdfunding companies, two tiers of Reg A companies, private companies, private companies using Reg D (or the smaller number of "sophisticated" investors allowed to buy Reg D securities under Section 506), SRCs, EGCs and fully reporting public companies.[109]

The Heritage study argues that the benefits of mandatory disclosure are lower than generally assumed.[110] The study proposes a dramatic reduction and simplification of these categories to three: private, quasi-public and public. Public companies could engage in general solicitation and would be above a certain threshold in size or have shares traded on a national exchange. Disclosure requirements would be based on some measure of the public float. Quasi-public companies could generally solicit and would involve companies that today operate under crowdfunding, Reg A or Rule 505 exemptions. Private companies would retain some provisions restricting purchase of securities to "accredited" investors.[111]

Although the details are important and often debatable, we generally agree with the need to reduce and simplify disclosure requirements, particularly on smaller companies. Such a reduction would reduce costs and free management to pursue growth and innovation.

6. Conclusions

Our research argues convincingly that there has been a long-term secular decline in initial public offerings since the late 1990s. The decline in IPOs has continued through several economic cycles and has also disproportionately affected smaller startups that might want—or need—to sell shares in the public markets. Our research also strongly suggests that there is no single cause of this decline; that, in fact, a variety of different factors have played roles, from fundamental shifts in the structure of capital markets and investing, to successive waves of re-regulation that have washed over public companies. Again, these factors

106 Lynch, Sarah. "U.S. SEC's Piwowar Urges Companies to Pursue Mandatory Arbitration Clauses." Reuters, July 18, 2017. https://www.reuters.com/article/us-usa-sec-arbitration/u-s-secs-piwowar-urges-companies-to-pursue-mandatory-arbitration-clauses-idUSKBN1A221Y.

107 Burton, David. "Backgrounder: Securities Disclosure Reform." Washington, DC: The Heritage Foundation, Feb. 13, 2017. http://www.heritage.org/sites/default/files/2017-02/BG3178.pdf, p. 2.

108 Ibid., p. 1.

109 Ibid., p. 2.

110 Ibid., p. 3.

111 Ibid., pps. 10-11.

have hit smaller companies disproportionately hard. Startups struggle to pay for the kinds of disclosure and compliance regimens demanded by Sarbanes-Oxley, Reg FD or Dodd-Frank—practices larger companies more easily shoulder. Growth and consolidation have made it increasingly less economical for sell-side firms to research and highlight smaller IPO candidates or for buy-side firms to invest in their IPOs. Even the markets themselves have been driven by reforms like decimalization, which produced smaller bid-ask spreads and furthered the larger goal of frictionless, efficient markets. Those gains, however, came at the cost of increasing the importance of larger-cap stocks with greater liquidity and further undermining the economics of sell-side research, which had already suffered a significant blow from the Global Analyst Research Settlement.

The larger question this study raises is: How much does this matter? Initial public offerings since their rise in the 1980s and '90s have assumed an outsized role in how we evaluate the health of our market system, particularly in terms of job creation and technological innovation. The benchmark usually employed is the number of IPOs that occurred in the '90s, a period that historically appears to represent a uniquely high plateau—until the bubble burst in 2000. In those decades, a number of market developments emerged organically that offered smaller, growing companies alternatives to the single pathway leading to the public markets—notably, but not exclusively, private equity, venture capital and growing levels of M&A. As private equity and venture capital matured, they could provide many of the benefits that public markets were struggling to offer: plentiful capital, lucrative compensation for senior executives, a long-term perspective and a tightly focused governance regime. (The downside: private equity portfolio companies will ultimately be sold, often in IPOs.) And companies that remained private, whether through private equity ownership or continued reinvestment by venture capital (the "unicorn" phenomenon), are able to operate without many of the regulatory burdens of their public peers, and without concerns that they will be taken over through M&A or driven to operate in a short-term fashion by shareholder activists.

In this paper, we have not directly tackled the related issue of the health of the public markets. The number of stocks has declined roughly in parallel with the post-2000 decline in IPOs, from just over 8,000 in 1996 to almost half of that today.[112] Some of this decline is clearly attributable to the growth of private equity and venture capital as viable financing options, though one of the exit options of these investors is the IPO. Still, while the effect of a shrinking number of stocks is important, particularly to investors in public stocks, and related to a dearth of IPOs, it is beyond our ambit here.

IPOs are important because they serve as a lone gateway to *public* ownership. We assume that there is value in a vibrant system of public ownership. What we have tried to capture in our policy recommendations is that there are incremental steps that can make it easier for companies to take the option of an IPO and successfully negotiate the often-difficult years that immediately follow. The JOBS Act was a start here, but it should certainly be revisited. Important steps include reducing the disclosure and, in some cases, regulatory burdens on these companies; extending the time period that emerging growth companies can operate in a regulatory- and disclosure-lite fashion; and tackling the problem of unrestrained shareholder litigation and burdensome cause-oriented share proposals. More generally, we can simplify and rationalize the nearly impenetrable thicket of financial regulation of public companies, a task that would clearly benefit both prospective and current public companies.

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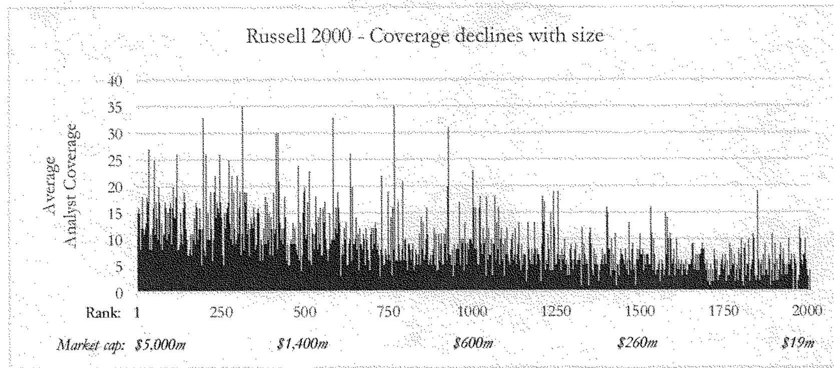
[112] "Listed Domestic Companies, Total, United States," The World Bank, World Federation of Exchanges database, accessed Dec. 18, 2017, https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US.

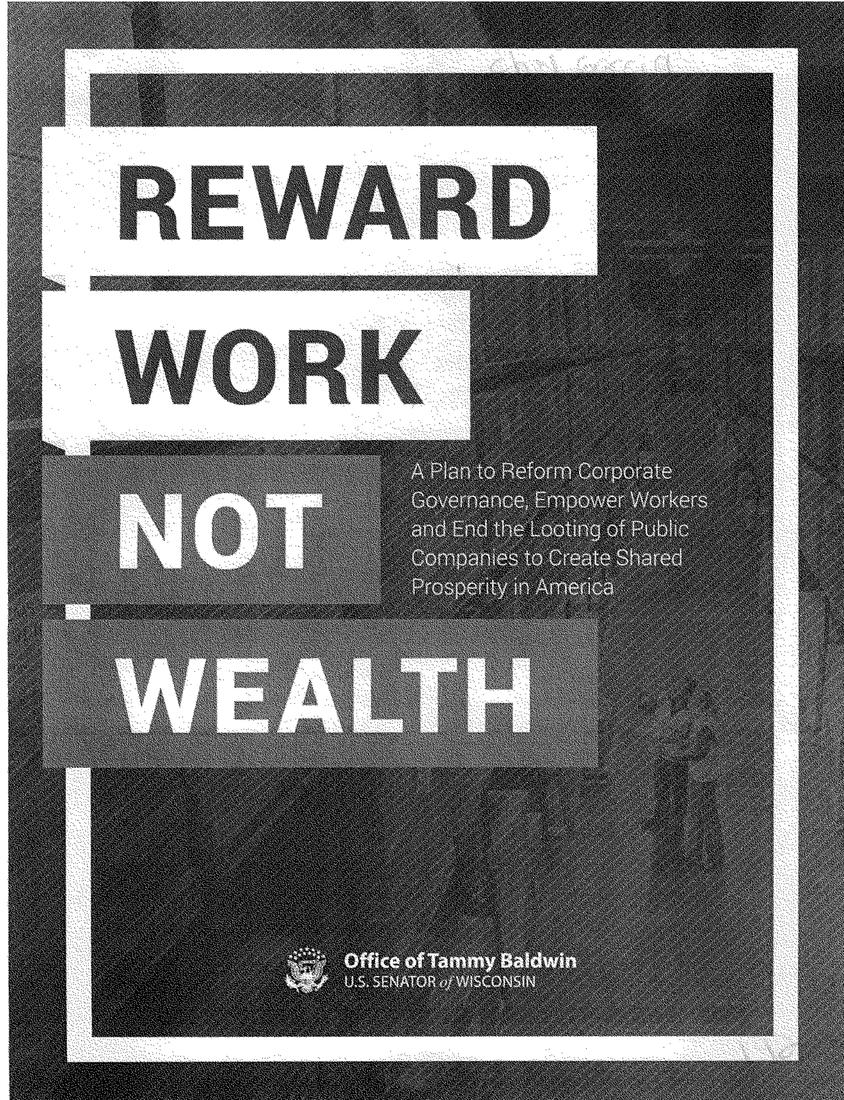
Appendix

Item 1 – SEC Filing Categories

Filer category	Public float	Form 10-K	Form 10-Q
Large accelerated filer	<$700m	60 days after fiscal year end	40 days after fiscal quarter end
Accelerated filer	$75m – $750m	75 days after fiscal year end	40 days after fiscal quarter end
Non-accelerated filer	<$75m	90 days after fiscal year end	45 days after fiscal quarter end

Item 2 – Russell 2000 Analyst Coverage
Index constituents and market caps sourced from Russell, analyst coverage data from Bloomberg.




REWARD
WORK
NOT
WEALTH
A Plan to Reform Corporate Governance, Empower Workers and End the Looting of Public Companies to Create Shared Prosperity in America
Office of Tammy Baldwin
U.S. SENATOR of WISCONSIN

REWARD WORK NOT WEALTH

Office of Tammy Baldwin
U.S. SENATOR *of* WISCONSIN

A Plan to Reform Corporate Governance, Empower Workers and End the Looting of Public Companies to Create Shared Prosperity in America

Dear Friends,

On March 22, 2018, I introduced the *Reward Work Act* in the United States Senate. The legislation was the first in Congress to ever propose the idea that workers at public companies should have a direct role in the governance of the businesses that employ them—an idea I have come to call "worker empowerment." In order to build on the success of last year's introduction, I am providing this report of research on the benefits of worker empowerment to accompany the re-introduction of the *Reward Work Act* in the 116th Congress. In addition to worker empowerment, the report provides research on the impact of rising stock buybacks and the Securities and Exchange Commission's (SEC) role in allowing shareholders and corporate executives to use buybacks to reward wealth, not work.

Today, a greater share of Americans work for a large corporation than at any point in our history—and the trend is growing.[1] The decisions made at large companies influence how much we earn and the cost of the products we buy. In the aggregate, these decisions reverberate through our economy and become part of our long-term economic trends. Lately, those trends have not been good: income inequality in the U.S. has steadily risen as wages have stagnated to the point that each new American generation is less likely to out earn its parents' generation.[2] Income inequality is now at levels last seen immediately preceding the Great Depression and researchers believe it is slowing the growth of our Gross Domestic Product (GDP) by 2 to 4 percent annually.[3]

In spite of (or possibly because of) their power, public companies are among the institutions least accountable to everyday Americans. We had a hunch that increasing the accountability at public companies could make their decisions benefit everyone, not just those at the top. In order to test our theory, we looked at companies that already provide workers an opportunity to participate equitably in corporate board-level decision making. This is common in Germany and a few other European countries. Here is what we found:

- Companies with worker representation invest *twice* the amount that similar firms without worker representation do;

1 Theo Francis, "Why You Probably Work for a Giant Company, in 20 Charts," *The Wall Street Journal*, April 6, 2017.

2 Jim Tankersley, "American Dream collapsing for young adults, study says, as odds plunge that children will earn more than their parents," *Washington Post*, December 8, 2016; Chetty et al, "The Opportunity Atlas: Mapping the Childhood Roots of Social Mobility," *National Bureau of Economic Research, October 2018.*

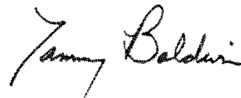
3 Gabriel Zucman, "Global Wealth Inequality," *National Bureau of Economic Research*, January 2019, Josh Bivens, "Inequality is slowing US economic growth," *Economic Policy Institute*, December 12, 2017.

- Companies with worker representatives on their boards created nine percent more wealth for their shareholders than comparable companies without board-level worker representation;
- Communities that are home to companies with worker representation distribute income more equally and provide their citizens greater economic opportunity; and,
- Wages in countries that require worker representation on corporate boards are 18 – 25 percent *higher* than wages in the United States.[4]

As a result of these findings, I became convinced that broadening the base of corporate decision-makers could yield more shared economic prosperity in the United States. That is why the *Reward Work Act* requires that one-third of the directors of each public company be elected by its employees. While this idea is bold, I have been pleasantly surprised to learn that most Americans agree with it. Public polling has shown strong support for this proposal among Democrats, Independents, and Republicans, resulting in a positive approval rating in every Congressional district in the country.[5]

The enclosed report provides detailed analysis to support findings on worker representation, stock buybacks, and the failure of the SEC to fulfill its mission. The SEC's misguided rules on buybacks allow executives and wealthy shareholders to extract undeserved cash from public companies. Given these results, it is clear to me that empowering workers—as envisioned in the *Reward Work Act*—would lead to better economic opportunities for many Americans. I hope that after reading the report, you will agree.

Sincerely,



Tammy Baldwin

United States Senator

4 *See* "Findings."

5 Data for Progress, *The New Progressive Agenda Project*, August 10, 2018. https://www.dataforprogress.org/the-new-progressive-agenda-project

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Executive Summary

The evidence presented in this paper supports three findings:

1. **Worker empowerment increases wages, investment, and firm performance; decreases offshoring; lowers income and wealth inequality, and provides upward economic mobility.**
   Nations with more worker empowerment have higher wages and higher real wage growth than the United States. Firms with worker empowerment produce nine percent higher returns for shareholders and undertake twice as much investment as firms that do not have workers on their boards. Finally, stronger worker participation on corporate boards is positively correlated with lower national levels of economic inequality and higher intergenerational socioeconomic mobility.

2. **Buybacks suppress wages, drive income and wealth inequality, decrease investment, increase systemic risk, harm retirement savers, and jeopardize capital formation by allowing speculators to extract value from public companies.**
   Buybacks increase shareholder wealth in the short term but decrease it in the long term, rewarding speculators and corporate executives who sell out while harming retirement savers who stick around. During 2014 – 2016, the 30 Dow Jones Industrial Average (DJIA) companies spent 126 percent of their income on dividends and buybacks. Executives call it "returning capital to shareholders," yet the vast majority of public-company shareholders bought their stock from other shareholders and therefore have never contributed financial resources to the firms whose shares they hold. Encouraged by stock-based executive pay and the "maximizing shareholder value" ideology, buybacks suppress wages and drive income and wealth inequality higher. Finally, the buyback binge has pushed corporate debt to record highs, increasing systemic risk.

3. **By refusing to address pervasive extraction of public-company value through stock buybacks, the SEC has failed in its mission.**
   In repeated communications to Congress, SEC Chairmen of both political parties have refused to re-evaluate the Commission's buyback rules or even commit resources to studying the buyback phenomenon. This is in spite of the direct tie from the SEC's Rule 10b-18 to the explosion of buybacks. By refusing to address the buyback phenomenon, the SEC has failed in its stated mission. The SEC proclaims its mission is to "protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation." There is

evidence that buybacks undermine all three components of this mission. SEC Commissioner Robert Jackson Jr. has shown that corporate insiders use buybacks to boost their stock-based compensation at the expense of other investors. Capital formation is undermined when companies spend in excess of their earnings and take on risky debt to buy back stock.

These findings are put in context in the background section, which explains the history of the public corporation; the consequences of the "shareholders first" ideology; and the role the stock market plays in the extraction of value from public companies.

The report provides a plan to address the problems raised by the findings, described in three policy recommendations:

1. **Require that one-third of the seats on each public company's board be directly elected by its workers.** To provide the workers—who create value—a say in how the company's profits are distributed.
2. **Ban open-market buybacks.** To end the value extraction from public companies by short-term speculators and corporate executives.
3. **Take legislative action.** To force the SEC to address the buyback problem it created with Rule 10b-18.[6]

6 In 1982 the SEC adopted Rule 10b-18, which provides corporate executives a safe harbor from charges of stock price manipulation when repurchasing company stock on the open market under certain conditions. For further reading on the history of 10b-18, see Lenore Palladino, "The $1 Trillion Question: New Approaches to Regulating Stock Buybacks," *Yale Journal on Regulation*, Vol. 36, 2018.

Background

Role of Public Corporations

Corporations are granted special rights and privileges in our society. Under the law, their shareholders are treated differently than sole proprietors or partners in a business partnership. Unlike other business organizations, corporations are treated as legal entities with interests separate from their shareholders' interests. Because shareholders hold transferrable stock for which there is a liquid market, they can easily transfer their interests, allowing the corporation to continue on if a shareholder wishes to terminate their interest. This separation provides **limited liability**, meaning that if the company fails, the shareholders will not be held responsible for the company's debts and vice versa—a shareholder's personal debts cannot be transferred to the company.[7] It is through these legal innovations that—over the course of the 20th century—shareholders became less likely to be direct investors in a company, and more likely to be portfolio investors—able to accumulate wealth while remaining separate from the company's day-to-day operations.

For much of American history, these legal rights were granted in exchange for a corporation's undertaking specific obligations. Corporate charters that granted these rights required the business to serve some public interest, building a road for example. However, the responsibilities placed on corporations by early corporate charters have been eroded by state governments and the courts, to the point that today many erroneously believe that the only legal obligation of the officers and directors of the corporation is to maximize yield for the corporation's shareholders, when in fact corporate law requires no such thing.[8] Today, the legal rights afforded to shareholders and corporations have retained their power, while the responsibilities have been whittled away.

7 Kent Greenfield, "The Failure of Corporate Law," *University of Chicago Press*, 2006.

8 Lynn Stout, "The Shareholder Value Myth," *Berrett-Koehler Publishers, Inc.*, 2012; Stout et al, "The Modern Corporation Statement on Company Law" Purpose of the Corporation Project, October 29, 2016 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2848833: "Contrary to wide-spread belief, corporate directors generally are not under a legal obligation to maximise profits for their shareholders. This is reflected in the acceptance in nearly all jurisdictions of some version of the business judgment rule, under which disinterested and informed directors have the discretion to act in what they believe to be in the best long term interests of the company as a separate entity, even if this does not entail seeking to maximise short-term shareholder value. Where directors pursue the latter goal, it is usually a product not of legal obligation, but of the pressures imposed on them by financial markets, activist shareholders, the threat of a hostile takeover and/or stock-based compensation schemes."

Problems with Shareholders First

The "maximizing shareholder value" ideology is pervasive and the concomitant rise in economic inequality raises serious questions about the ideology's effect on the way corporations allocate their financial resources.[9] We should begin by examining those the ideology purports to put first—shareholders. To illustrate, consider that the CEO of the world's largest asset manager, Larry Fink of BlackRock, has called on chief executives to ensure that their companies serve a social purpose that benefits all of their stakeholders, "including shareholders, employees, customers, and the communities in which they operate." Fink believes that companies that do not articulate a social benefit will "lose the license to operate from key stakeholders."[10]

While BlackRock at least claims to represent the interests of long-term shareholders, there are many[11] shareholders who, for various reasons, have a far shorter time horizon[12] and demand that public companies make decisions that generate high yield immediately. Compounding the pressure for short-term performance, corporate managers' compensation is increasingly tied to manipulative boosts of the company's share price. Stock-based pay now makes up as much as 82 percent of the compensation of the nation's highest-paid executives.[13] This provides strong incentives for actions like buybacks that might provide a share-price pop in the short term, but hurt the firm's competitiveness long term—creating a mechanism by which some shareholders can **extract value** from the company.[14]

In order to benefit from an increased share price, a shareholder must *sell*, severing their relationship with the company. The ability to cut ties with the company quickly and easily is unique to shareholders among the company's stakeholders. A **share-seller** receives cash—usually from the company's retained earnings or from a loan—in exchange for their share. This is how activist shareholders and CEOs are able to extract value from companies (more on that in the next section). In contrast, other stakeholders, like workers and taxpayers, contribute

9 William Lazonick and Mary O'Sullivan, "Maximizing Shareholder Value: A New Ideology for Corporate Governance," *Economy and Society*, 29, 1, 2000: 13-35; Jia Lynn Yang, *Maximizing shareholder value: The goal that changed corporate America*, The Washington Post, August 26, 2013; James Montier, *The World's Dumbest Idea*, GMO White Paper, December 2014.

10 Larry Fink, *2018 Letter to CEOs*: "A Sense of Purpose," *BlackRock*, 2018, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter

11 Lindsay Fortado, "Investing: activism enters the mainstream," *Financial Times*, February 14, 2018, https://www.ft.com/content/e04547b8-0d0b-11e8-839d-41ca06376bf2

12 Sam Ro, "Stock Market Investors Have Become Absurdly Impatient," *Business Insider*, August 7, 2012, https://www.businessinsider.com/stock-investor-holding-period-2012-8

13 William Lazonick, "The Value Extracting CEO," *Institute for New Economic Thinking*, December 3, 2018

14 Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," *National Bureau of Economic Research*, January 11, 2005; Keasler & Byerly, "An Examination of Corporate Stock Buybacks: Do They Really Create Value?", *Economics, Management, and Financial Markets*, October 21, 2014.

productive resources, labor in the case of workers and public goods in the case of taxpayers, that are used to **create value** at the company. Yet increasingly, these contributions are receiving less in return—in wages and in tax revenue. The *value creators are losing out to the value extractors* and the implications for our economy are far reaching.

The chief consequence of the warped priorities of public companies is that wage growth has consistently fallen short of productivity growth since the late 1970s.[15] While shareholders are reaping the gains of higher productivity and higher profits—that is, benefiting from the engine of economic growth—workers have not gotten their fair share. This is particularly inequitable when one considers that productivity gains are driven by worker innovation.[16]

Finally, we should consider how taxpayers (and by extension, members of the local community) fare under the shareholders first ideology. Taxpayers invest in resources that corporations put to productive use. For example, they pay for infrastructure, education, market regulation, and public health—all resources that business corporations draw heavily upon to make profits.[17] And yet, the amount that corporations provide to the Treasury in federal tax revenue was declining even before President Trump's Tax Cuts and Jobs Act dramatically lowered the corporate rate.[18] The tax bill helped shareholders continue their value extraction as companies announced over $1 trillion in buybacks in 2018,[19] while only 14 percent of companies said they would use the tax cuts to increase workers base salaries.

15 William Lazonick, "Profits Without Prosperity," *Harvard Business Review*, September 2014, https://hbr.org/2014/09/profits-without-prosperity

16 William Lazonick, "The Theory of Innovative Enterprise," *Academic-Industry Research Network*, February 2013; William Lazonick and Tony Huzzard, "Corporate Governance, Employee Voice, and Work Organization: Sustaining High-Road Jobs in the Automotive Supply Industry," *Oxford University Press*, April 30, 2014.

17 Matt Hopkins and William Lazonick, "Who Invests in the High-Tech Knowledge Base?", *Institute for New Economic Thinking*, May 2014

18 Center on Budget and Policy Priorities, *Policy Basics: Where Do Federal Tax Revenues Come from?*, December 6, 2018, https://www.cbpp.org/research/federal-tax/policy-basics-where-do-federal-tax-revenues-come-from; Pub. L. 115 – 97.

19 Emily Stewart, "What the Republican tax bill did – and didn't – do, one year later," *Vox*, December 22, 2018, https://www.vox.com/policy-and-politics/2018/12/18/18146253/tax-cuts-and-jobs-act-stock-market-economy

The Role of the Stock Market

> *"Conventional wisdom has it that the primary function of the stock market is to raise cash for companies for the purpose of investing in productive capabilities. The conventional wisdom is wrong. Academic research on the sources of corporate finance shows that, compared with other sources of funds, stock markets in advanced economies have been insignificant suppliers of capital for corporations."*
> **– William Lazonick**

As discussed earlier, because corporations have diverse shareholders, any given shareholder can terminate their stake without threatening the continuity of the company's operations. While diverse shareholder interests can make it easier for corporations to raise money, this is not the primary reason major U.S. stock markets that trade in these shares developed. The histories of the New York Stock Exchange and NASDAQ show quite clearly that they were developed by industrialists and their financiers seeking to exit their investments, rather than to raise new capital for the corporation to put to productive use.[20]

This is how the stock market still works today. Professor William Lazonick has shown that cash from equity investors is an insignificant source of funds for public companies.[21] According to data from the Federal Reserve, through stock buybacks and mergers, stock markets were used to siphon an annual average of $412 billion in cash *out* of public companies from 2006 to 2016.[22]

Therefore, the vast majority of shareholders in American public companies—having purchased their shares from other shareholders on the secondary market—contribute zero cash to the company's balance sheet. And yet, public-company management's incentives are aligned to prioritize what is inaccurately termed "returning capital to shareholders."[23] In order to demonstrate why this is a misnomer, let's review the example of activist investor Carl Icahn and Apple. Icahn purchased $3.6 billion of Apple shares in 2013 and 2014.[24] Despite the characterization of

20 Thomas Navin and Marion Sears, "The Rise of a Market for Industrial Securities, 1887–1902," *Business History Review*, 1955; Mary O'Sullivan, "The Expansion of the U.S. Stock Market, 1885 1930: Historical Facts and Theoretical Fashions," *Enterprise and Society*; Mary A. O'Sullivan, "Dividends of Development: Securities Markets in the History of U.S. Capitalism," 1865-1922, *Oxford University Press*, 2016.

21 William Lazonick, *The Functions of the Stock Market and the Fallacies of Shareholder Value*, Institute for New Economic Thinking, July 20, 2017.

22 Ibid.

23 William Lazonick, "Apple's 'Capital Return Program': Where Are the Patient Capitalists?", *Institute for New Economic Thinking*, November 13, 2018, https://www.ineteconomics.org/perspectives/blog/apples-capital-return-program-where-are-the-patient-capitalists

24 Nathan Vardi, "Carl Icahn Makes Huge $3 Billion Bet on Apple," *Forbes*, January 22, 2014 https://www.forbes.com/sites/nathanvardi/2014/01/22/carl-icahn-makes-huge-3-billion-bet-on-apple/#3120db845727; Neil Hughes, "Carl Icahn invests another $500M in Apple, promotes increased buyback in letter to shareholders," *Apple Insider*, January 23, 2014, https://appleinsider.com/articles/14/01/23/carl-icahn-invests-another-500m-in-apple-promotes-increased-buyback-in-letter-to-shareholders; Carl Icahn, "Open Letter to Apple Shareholders," January 23, 2014 https://carlicahn.com/apple_shareholder_letter/.

this purchase by Icahn and the media as an "investment," Icahn Enterprises' cash doesn't end up on Apple's balance sheet for the company to put to productive use. When Apple wants to research and develop its next innovative gadget, it doesn't have Icahn's cash at its disposal. That is because—as is the case with most stock purchases—Icahn bought his shares from other shareholders, not the issuing company (Apple in this case).

Despite contributing zero to Apple's balance sheet, Icahn still loudly demanded that Apple accelerate its buyback program. Apple did—and it has now spent over $239 billion on buybacks since 2012.[25] Apple calls its buyback program the "Capital Return Program," yet the company isn't *returning* cash to shareholders like Icahn, because they haven't given the company anything. Icahn sold his Apple shares after holding them for 32 months for a $2 billion gain. This example illustrates how activist investors use stock markets to take cash out of companies, rather than supply companies cash to put to productive use—rewarding the wealth of the activist, not the work of the employee who generated the profits.

25 Carl Icahn, "Carl Icahn Issues Open Letter to Tim Cook," May 18, 2015 https://carlicahn.com/carl-icahn-issues-open-letter-to-tim-cook/; William Lazonick, "Apple's 'Capital Return Program': Where Are the Patient Capitalists?", *Institute for New Economic Thinking*, November 13, 2018, https://www.ineteconomics.org/perspectives/blog/apples-capital-return-program-where-are-the-patient-capitalists

Findings

Many of the findings below are drawn from examples of worker empowerment in Europe. Of the 31 nations in the European Economic Area, 19 require employee representation on corporate boards. In 13 of these, worker empowerment rights exist not just in state-owned or recently privatized companies, but in most large private business sector companies.

● **Finding #1:** Worker Empowerment Increases Wages, Investment, and Firm Performance; Decreases Offshoring; Lowers Income and Wealth Inequality, and Provides Upward Economic Mobility

EXHIBIT 1: Higher Wages, Growth in Nations with Worker Empowerment
According to the U.S. Department of Labor, total compensation for all Americans employed in the private sector in 2017 averaged $35.51 per hour. Adjusted for inflation and purchase power parity, hourly wages in 2017 in the five largest co-determination economies averaged 18 to 25 percent higher. Further, the five largest nations with co-determination (France, Germany, the Netherlands, Norway, and Sweden) averaged 7.3 percent wage growth after inflation across all occupations between 2010 and 2017. This increase was more than double the rise in the U.S. over the same period.[26]

EXHIBIT 2: When on Corporate Boards, Workers Improve Firm Performance
In 2006, in the *Journal of Financial Economics*, two economists published research showing that the German corporate-governance system—which requires worker representation on the board of directors—ensured that corporate decision-making would benefit from valuable first-hand operation knowledge provided by workers. The result was improved firm performance: "[f]irms with employee representation are significantly larger with respect to sales and assets and are relatively more profitable." When labor represented between one-third and one-half of board seats, shareholder wealth increased by almost nine percent. Further, research from William Lazonick and Tony Huzzard found, "that the involvement of workers in enhancing productivity increases both the earnings of workers and the competitiveness of the products that they produce. There is fresh evidence of the importance of worker involvement in the productivity improvements that contribute to making their own

26 George Tyler, "The Codetermination Difference," *The American Prospect*, January 10, 2019; Bureau of Labor Statistics, "Employer Costs for Employee Compensation," March, June, September, December 2017 https://www.bls.gov/web/ecec/ececqrtn.pdf; Eurostat, "Investment rate of non-financial corporations," August 17, 2018 at https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Hourly_labour_costs_in_euro_CORR.png

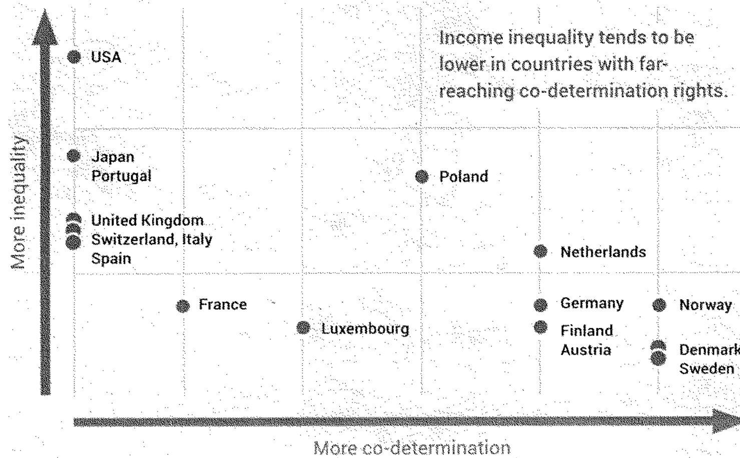
jobs, and the companies for which they work, competitive on a global scale."[27]

EXHIBIT 3: Firms with Worker Empowerment Invest at Higher Rates Than Those Without

Investment data from 2006 to 2016 shows non-financial public firms in the U.S. trailing those in all European co-determination countries in investment. Researchers at the Berlin Social Science Center concluded in a 2016 analysis of German enterprises that capital investment at co-determination firms was twice that at firms lacking co-determination.[28]

Strong co-determination, fair distribution

Income inequality and co-determination (at board level) in ....



Income distribution based on the Gini-coefficient; degree of co-determination according to 'Co-determination Index'
Source: Hans-Boeckler Foundation **Download:** bit.do/implus0928

Hans Böckler Stiftung

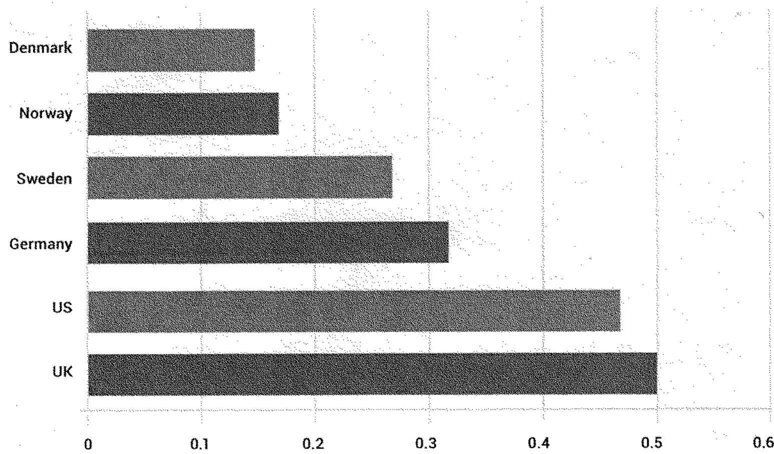
27 Larry Fauver, Michael Fuerst, "Does good corporate governance include employee representation? Evidence from German corporate boards," *Journal of Financial Economics*, December 2006, pgs 673-710; William Lazonick and Tony Huzzard, "Corporate Governance, Employee Voice, and Work Organization: Sustaining High-Road Jobs in the Automotive Supply Industry," *Oxford University Press*, April 30, 2014.

28 Eurostat, "Non-financial corporations-statistics on profits and investment: Investment rates between 2006 and 2016," May 2018 at https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Non-financial_corporations_-_statistics_on_profits_and_investment#Investment_rates_between_2006_and_2016; Hans-Boekler Foundation, "Where employees have a say, more is invested," June 27, 2016 at https://www.mitbestimmung.de/html/wo-arbeitnehmer-mitbestimmen-wird-mehr-5004.html; European Foundation for the Improvement of Living and Working Conditions, "Social partners divided over issue of co-determination at company level," January 3, 2007, at https://www.eurofound.europa.eu/publications/article/2007/social-partners-divided-over-issue-of-co-determination-at-company-level

EXHIBIT 4: Stronger Co-determination Is Associated with Fairer Distribution
In 2012, a leading international think tank found co-determination rights led to lower levels of income inequality in an analysis of 32 Western countries. The Hans-Boeckler Foundation has found a trend indicating that nations with stronger co-determination rights had more equitable income distributions. While there are many variables that affect distribution (measured here by the Gini coefficient), the fact that there are varying levels of co-determination rights provides a strong indication that stronger rights are correlated with higher economic equality. This is a question of economic efficiency as well as fairness. The Economic Policy Institute estimates that rising wage inequality has created a significant drag on GDP growth in recent years.[29]

EXHIBIT 5: Worker Empowerment Increases Economic Opportunity, Mobility
The lack of economic opportunity in the United States is well documented. Not only are wages stagnant, but children are becoming increasingly less likely to earn more than their parents did. Children in Northern European nations with strong

Intergenerational Earnings Elasticity
(Odds of a son being in the same earnings quintile as his father)



Source: George Tyler

29 Felix Horisch, "The Macro-economic Effect of Codetermination on Income Equality," *Mannheim Center for European Social Research*, 2012; Hans-Boekler Foundation, Josh Bivens, "Inequality is slowing US economic growth," *Economic Policy Institute*, December 12, 2017.

co-determination are two to three times more likely than their American peers to move up the socioeconomic ladder.[30]

EXHIBIT 6: Companies with Strong Co-determination Rules Outsource Fewer Jobs

A review of DAX30 companies (German equivalent of the Dow Jones Industrial Average) found that large multinational German companies with co-determination, and abundant overseas sales, maintained a greater percentage of jobs at home than German firms with comparable overseas sales but no co-determination. This data suggests that without worker input, companies are more likely to send jobs overseas. Further, the German companies with co-determination bring back foreign profits to create jobs at home, something that both recent repatriation efforts in the U.S. have failed to achieve.[31]

EXHIBIT 7: Workers May Discourage Mergers, Improve Market Competition

Over 40 percent of respondents to a November 2006 German survey of co-determination firm executives believed that co-determination was either a "slight" or "great obstacle" to mergers with other German firms or foreign firms.

30 George Tyler, "How to Establish More Balance in the Top-Heavy US Economy?", *The Globalist*, January 21, 2019 at https://www.theglobalist.com/us-europe-capitalism-inequality-codetermination/; Raj Chetty et al, "Is the United States Still a Land of Opportunity? Recent Trends in Intergenerational Mobility," *National Bureau of Economic Research*, January 2014

31 George Tyler, "The Codetermination Difference," *The American Prospect*, January 10, 2019, https://prospect.org/article/codetermination-difference; Rubin and Francis, "Trump Promised a Rush of Repatriated Cash. But Company Responses are Modest," *The Wall Street Journal*, September 16, 2018 https://www.wsj.com/articles/companies-arent-all-rushing-to-repatriate-cash-1537106555

Finding #2: Buybacks Suppress Wages, Drive Income and Wealth Inequality, Decrease Investment, Increase Systemic Risk, Harm Retirement Savers, and Jeopardize Capital Formation by Allowing Speculators to Extract Value from Public Companies

EXHIBIT 8: Buybacks Are Suppressing Wages and Increasing Economic Inequality
From the post-WWII period until the late 1970s, productivity gains and workers' wages increased in tandem. Changes in the management of public companies, and the SEC's 1982 rule providing a safe harbor to those repurchasing shares on the open market, contributed to a decoupling of productivity gains and workers' wages. The U.S. has experienced decades of middle-class wage stagnation despite rising profits and productivity because of the downward pressure that buybacks put on wages. This has driven inequality to levels not seen since the period immediately preceding the Great Depression.[32]

EXHIBIT 9: Buybacks Hurt Retirement Savers, Reward Stock Speculators
Two different studies have shown that buybacks hurt shareholders who invest for the long term, such as retirement savers. In the first, Terrill Keasler and Robin Byerly found that buyback announcements increased shareholder wealth after one-day and ten-day periods. However, the researchers found that shareholder wealth at buyback companies *declined* when measured over five-year and ten-year periods. In the second study, Robert Ayers and Michael Olenick showed "that there is a strong causal relationship between buybacks and *lower growth rates*." For retirement savers—average people who invest in public companies for long term gains—this research clearly demonstrates that buybacks hurt their returns.[33]

EXHIBIT 10: Buybacks and Demand for Short-Term Results Have Led to Decreased Investment, Hurting Company Value
Analysis by the Roosevelt Institute has shown that while "firms once borrowed to invest and improve their long-term performance, they now borrow to enrich their investors in the short run." The study found that, "in the 1960s and 1970s, each additional dollar of earnings or borrowing was associated with a 40-cent increase in investment. Since the 1980s, less than 10 cents of each borrowed dollar is invested." A separate analysis by Roosevelt found that investment growth is very

32 William Lazonick, "Profits Without Prosperity", *Harvard Business Review*, September 2014, https://hbr.org/2014/09/profits-without-prosperity; Stanford Center on Poverty & Equality, "20 Facts About U.S. Inequality that Everyone Should Know," *Publications*, 2011, at https://inequality.stanford.edu/publications/20-facts-about-us-inequality-everyone-should-know

33 Keasler & Byerly, "An Examination of Corporate Stock Buybacks: Do They Really Create Value?", *Economics, Management, and Financial Markets*, October 21, 2014; Ayers & Olenick, "Secular Stagnation (Or Corporate Suicide?)," *INSEAD Working Paper*, July 11, 2017.

weak relative to that seen in previous business cycles and has been restrained by corporate preferences for shareholder payouts. A 2017 survey by Boston Consulting Group found "capital expenditure levels relative to revenues at a 20-year low, having dropped almost 20 percent between 1995 and 2015." The consultancy found that companies that are valued in the top third of their industry groups "invest approximately 50 percent more in capital expenditure than their peers and achieve approximately 55 percent higher returns on assets, and approximately 65 percent higher sales growth."[34]

EXHIBIT 11: Stock Markets Pull Trillions out of Public Companies with Buybacks
According to Worm Capital, between 2010 and 2016, "over $3 trillion in cash has been taken from corporate accounts and sent to the stock market for buybacks, generating zero tangible benefit for stakeholders—mainly shareholders." Over the period 2014 to 2016, the 30 companies in the DJIA spent an average of *126 percent of their income* on dividends and buybacks. General Electric spent *354 percent of its income* on buybacks and dividends, which has no doubt contributed to its decline.[35]

34 JW Mason, "Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment," *Roosevelt Institute*, February 25, 2015; JW Mason, "Understanding Short-Termism, Questions and Consequences," *Roosevelt Institute*, November 6, 2015; Ulrich Pidun and Sebastian Stange "The Art of Capital Allocation," *Boston Consulting Group*, March 27, 2017.

35 Arne Alsin, "Stock Buybacks: What corporations are not telling you," *Worm Capital*, November 2017 https://www.wormcapital.com/insights/stock-buybacks-report-worm-capital

EXHIBIT 12: Stock-Based Pay Is Warping Corporate Decision-Making
A study that surveyed 401 financial executives found that "the majority of managers would avoid initiating a positive [net present value] project if it meant falling short of the current quarter's consensus earnings target."[36] Similarly, over 75 percent of those surveyed would forgo creating economic value in exchange for "smooth earnings." The managers said that because predictable earnings drive higher share prices (which trigger bonus payments), achieving earnings predictability was preferable to improving the firm's performance.[37]

Source: 720 Global

36 Net present value is the sum of expected cash inflows and outflows over a certain time horizon

37 Graham, Harvey, and Rajgopal, "The Economic Implications of Corporate Reporting," *National Bureau of Economic Research*, January 11, 2005.

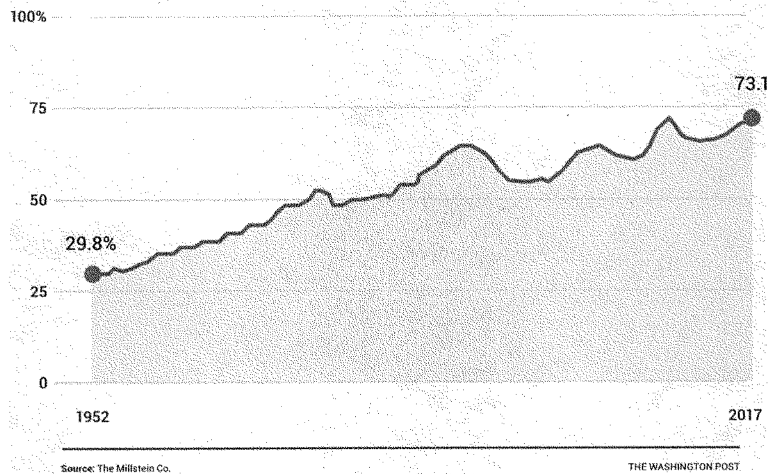


EXHIBIT 13: Buybacks have Created a Dangerous Corporate Debt Bubble

As Steven Pearlstein has written in *The Washington Post*, "The most significant and troubling aspect of this buyback boom, however, is that despite record corporate profits and cash flow, at least a third of the shares are being repurchased with borrowed money, bringing the corporate debt to an all-time high, not only in an absolute sense, but also in relation to profits, assets and the overall size of the economy." Corporate debt is at a record high and still rising, with total credit issued to nonfinancial companies as a percentage of GDP reaching 73.1 percent in 2017. Buybacks are increasingly fueled by corporate borrowing, in particular leveraged loans—which are extended to companies that already have high debt levels. Companies are able to borrow because there is strong investor demand for higher-risk, higher-yield leveraged loans—especially when they're sliced up, packaged into different tranches of risk, and sold. This dynamic has led former Fed Chair Janet Yellen to say, "I am worried about the systemic risks associated with these loans. There has been a huge deterioration in standards; covenants have been loosened in leveraged lending."[38]

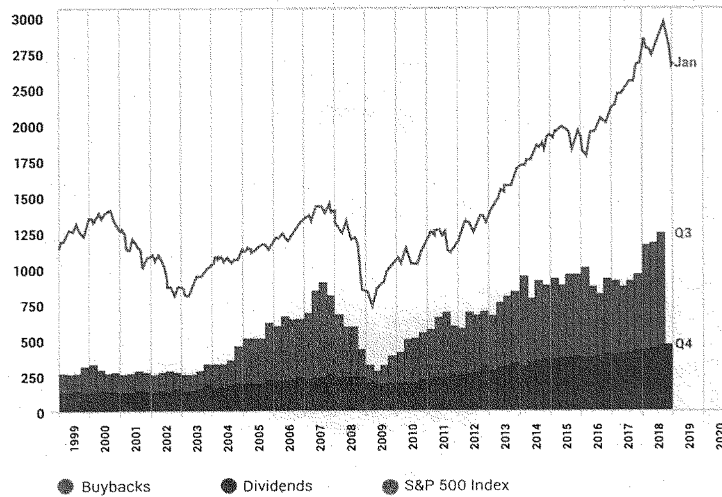
38 Steven Pearlstein, "Beware the 'mother of all credit bubbles'", *The Washington Post*, June 8, 2018; Megan Greene and Dwight Scott, "Do leveraged loans pose a threat to the US economy?", *Financial Times*, February 11, 2019; Brian Chappatta, "Leveraged-Loan Protections Go From Bad to Worse," *Bloomberg*, January 24, 2019.

EXHIBIT 14: Open Market Buybacks Are Almost Always Bought at Excessive Prices

As William Lazonick wrote in *Harvard Business Review*, "Though executives say they repurchase only undervalued stocks, buybacks increased when the stock market boomed, casting doubt on that claim." The chart below shows buyback activity peaking and dipping in unison with the S&P 500 market index. By definition, if executives are buying high and selling low, they are managing their company's cash poorly, which should disturb all of their stakeholders—not just shareholders, but bondholders, employees, and taxpayers—as the potential for insolvency rises.[39]

S&P Dividends & Buybacks

(trillion dollars, annualized)



Source: Standard & Poor's, Yardeni Research Inc.

EXHIBIT 15: Executives Use Buybacks to Cash Out at Retirement Savers' Expense

On June 11, 2018, SEC Commissioner Jackson published research showing that "executives personally capture the benefit of the short-term stock-price pop created by the buyback announcement." Corporate executives are twice as likely to sell their compensation stock in the eight days following a buyback announcement as they are on an ordinary day.[40]

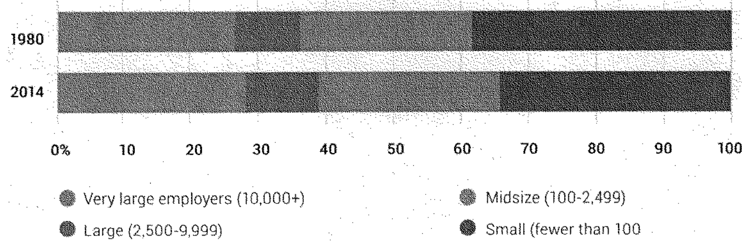
39 Edward Yardeni, "Stock Market Indicaors: S&P 500 Buybacks and Dividends," *Yardeni Research*, February 15, 2019; William Lazonick, "Profits Without Prosperity," *Harvard Business Review*, September 2014, https://hbr.org/2014/09/profits-without-prosperity

40 Robert J. Jackson Jr., "Stock Buybacks and Corporate Cashouts," *U.S. Securities and Exchange Commission*, June 11, 2018, https://www.sec.gov/news/speech/speech-jackson-061118#ftn22

EXHIBIT 16: Large Public Corporations Have Increasing Power over Workers and Economy

Americans are now more likely to work at a large company than ever before. "In the late 1970s, an American employee was more likely to work at a company with fewer than a hundred workers than one that employed 2,500 or more. Today, Americans are more likely to work for the larger firms." This evidence suggests that these larger firms' capital allocation strategies and labor practices are having an increased impact on American workers and our economic lives.[41]

Share of total employment by employer size



Source: Census Bureau THE WALL STREET JOURNAL

EXHIBIT 17: The Tax Cuts and Jobs Act Led to Buybacks, Little Economic Benefit To General Economy

American firms announced over $1 trillion in buybacks in 2018 after the Trump tax cuts, while workers' wages increased at barely the rate of inflation. Business investment increased after the tax bill but has fallen for four out of the last five months.[42]

41 Theo Francis, "Why You Probably Work for a Giant Company, in 20 Charts," *The Wall Street Journal*, April 6, 2017.

42 The New York Times Editorial Board, "You Know Who the Tax Cuts Helped? Rich People," *The New York Times*, August 12, 2018, https://www.nytimes.com/interactive/2018/08/12/opinion/editorials/trump-tax-cuts.html; Sharon Nunn, "Business Investment Falters Amid Growing Global Economic Uncertainty," *The Wall Street Journal*, February 21, 2019, https://www.wsj.com/articles/u-s-durable-goods-orders-rose-in-december-11550756072?mod=djemRTE_h

Finding #3: By Refusing to Address Pervasive Extraction of Value from Public Companies through Stock Buybacks, the SEC Has Failed in Its Mission

EXHIBIT 18: The SEC Is Failing in Its Mission

The SEC's declares its mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." Yet all three of these goals are undermined by the Commission's encouragement of open-market stock buybacks through Rule 10b-18. Commissioner Jackson has shown how ordinary shareholders are defrauded by corporate insiders who use buybacks to manipulate the prices of the shares they are awarded as compensation. This practice clearly violates the Commission's goal of protecting investors and keeping markets fair. As the previous section demonstrated, buybacks threaten capital formation by sending a corporation's retained earnings out to shareholders in the form of buybacks. Companies are taking on record amounts of debt to buy back stock instead of using their retained earnings to finance reinvestments into the company and create value.

EXHIBIT 19: SEC Leadership Gave Bogus Excuse for Refusing to Study Buybacks

On July 13, 2015, in response to a request from Senator Baldwin to study stock buybacks, SEC Chair Mary Jo White claimed that the Commission lacked the necessary data to provide an analysis to the Senator on the effects of buybacks on investors, markets, and the economy. Chair White wrote, "performing data analysis for issuer stock repurchases presents significant challenges because detailed trading data regarding repurchases is not currently available." This claim stands in direct contrast to research published by Commissioner Jackson, who used *publicly available data* to show that "executives are using buybacks as a chance to cash out their compensation at investor expense."[43] This raises serious questions about the Commission's mission and how it views its obligations to Congress.

EXHIBIT 20: The SEC Cannot Articulate How Its (Lack of) Regulation of Stock Buybacks Fulfills Its Mission

On June 28, 2018, Senator Baldwin and 20 of her colleagues wrote to SEC Chairman Jay Clayton to request that he review SEC Rule 10b-18, which provides a "safe harbor" for buybacks. The request was prompted by record-breaking buybacks following the passage of the Tax Cuts and Jobs Act, as well as research from Commissioner Jackson that found that "the percentage of insiders selling shares more than doubled immediately following their companies' buyback announcements." In response, Chairman Clayton said that the Commission does

43 Mary Jo White, "Response to Senator Baldwin," *U.S. Securities and Exchange Commission*, July 13, 2015, https://www.baldwin.senate.gov/imo/media/doc/SENATOR%20BALDWIN%20-%20STOCK%20REPURCHASES%20-%20ES153283%20Response.pdf

not have the authority to "prescribe actions in the area of corporate planning, execution, and performance," within which falls the decision to repurchase shares. Chairman Clayton did not respond to the Senators' concerns about how buybacks are undermining capital formation; harming fair, orderly, and efficient markets; or defrauding investors.[44]

EXHIBIT 21: The SEC Is Not Monitoring Stock Buybacks

In April 2015, Senator Baldwin wrote to SEC Chair Mary Jo White "with concerns about the recent explosion in stock buybacks by U.S. corporations." Senator Baldwin requested that the SEC, as the regulator responsible for fair and efficient capital markets, provide any analysis it had undertaken on the long-term impact of the 1982 SEC Rule 10b-18 (which provides a safe harbor for buybacks). In her response, Chair White noted that "detailed trading data regarding repurchases is not currently available" and had no response to questions about the proposed long-term economic impacts of the SEC's rules.[45]

EXHIBIT 22: The SEC Refused to Discuss How Worker Empowerment Could Improve Capital Formation

On October 15, 2018, Senator Baldwin and 12 of her colleagues wrote to SEC Chairman Clayton to request that the Commission's "Staff Roundtable on the Proxy Process" add agenda topics "address[ing] the obligations of corporations to *all* of their public stakeholders, including employees, consumers, local communities, and taxpayers—in addition to public shareholders." Despite Chairman Clayton's response, in which he said he felt "confident that the topics you raise . . . are likely to be well discussed," there was no mention of them at the roundtable, even though the Chairman Clayton was present at the discussion.[46]

44 Baldwin et al, "Senators Letter to Clayton on Buyback Rules," Office of Senator Tammy Baldwin, June 28, 2018, https://www.baldwin.senate.gov/imo/media/doc/Senators%20Letter%20to%20Clayton%20on%20Buyback%20Rules%20FINAL.SIGNED.6.28.18.pdf; Jay Clayton, "Response to Baldwin et al," Office of Senator Tammy Baldwin, September 12, 2018, https://www.baldwin.senate.gov/imo/media/doc/Baldwin%20et%20al%20-%20Stock%20Buybacks%20-%20ES157032%20Response.pdf

45 David Dayen, "SEC Admits It's Not Monitoring Stock Buybacks to Prevent Market Manipulation," *The Intercept*, August 13, 2015.

46 Tammy Baldwin et al, "Letter to Clayton on Proxy Roundtable," Office of Senator Tammy Baldwin, October 15, 2018, https://www.baldwin.senate.gov/imo/media/doc/Proxy%20Roundtable%20Signed%20Final%2010.15.18.pdf; Jay Clayton, "Response to Baldwin et al," Office of Senator Tammy Baldwin, November 7, 2018, https://www.baldwin.senate.gov/imo/media/doc/Baldwin%20-%20Proxy%20Roundtable%20(Clayton%20Response)1.pdf

EXHIBIT 23: Rule 10b-18 Opened the Door to the Buyback Explosion

According to an analysis from Worm Capital, during the three years prior to 10b-18, 1979 – 1981, companies in the DJIA spent $16.7 billion on buybacks and $152.3 billion on dividends. In the years 2014 to 2016, DJIA companies spent $580.5 billion on buybacks and $435.4 billion on dividends. Companies have gone from spending ten percent of the amount of their dividends on buybacks to now spending almost one third *more* on buybacks than they do on dividends. According to an analysis by Erdem Sakinc, the 226 companies that have been in the S&P 500 continuously since 1981 *alone* have distributed $5 trillion in 2017 dollars as buybacks and $4.8 trillion as dividends, equal to 87 percent of those companies' profits, during the 1981 to 2017 period. Since the adoption of Rule 10b-18 in 1982, all listed firms have spent a total of $10.7 trillion on buybacks. In 1981, the S&P 500 spent approximately two percent of its profits on buybacks. In 2017, those same companies spent 59 percent of their profits on buybacks.[47]

47 Erdem Sakinc, "Calculations for Senator Baldwin," *Academic-Industry Research Network*, March 3, 2019; Lazonick and Jacobson, "End Stock Buybacks, Save the Economy," *The New York Times*, August 23, 2018; Arne Alsin, "Stock Buybacks: What corporations are not telling you," *Worm Capital*, November 2017 https://www.wormcapital.com/insights/stock-buybacks-report-worm-capital

Policy Recommendations

The findings above show that the American system of corporate governance yields economic outcomes far inferior to those in nations with stronger worker empowerment. The evidence also shows that Wall Street insiders and corporate executives have abused the American system of corporate governance, spending trillions on buybacks to benefit themselves at the expense of employees and other corporate stakeholders. In light of these findings, which are based on extensive evidence, this report recommends the following policy changes.

Recommendation 1: Empower Workers to Elect Directors to Corporate Boards

The aggregate evidence from comparison countries provides strong support for the theory that worker empowerment can foster several key economic benefits, most notably: higher wages, improved firm performance, increased investment, less offshoring, lower income inequality, and greater socioeconomic opportunity.

In order for firms to achieve better performance, workers must have truly *board-level* representation that allows them to influence corporate decision-making. Research from Larry Fauver and Michael Fuerst, referenced in Exhibit 2, shows that results only become significant once workers have voting representation equal to at least one-third of the board. In other words, simply providing workers a forum to blow off steam will not yield results.

Requiring that workers directly elect one-third of corporate boards will ensure that value creators are able to reap the rewards of their labor. Workers invest their time, skill, and effort in the company and depend on managers both to generate a return on that investment and to share that return in the form of increased compensation. Workers also face much higher switching costs than shareholders (the average job hunt is currently over 20 weeks).[48] And while shareholders are given the ability to ignore the day-to-day operations of the company, the workers live those operations in their personal as well as their professional lives—workers almost always reside in the community in which their employer operates. Finally, because taxes on wages make up an increasing percentage of federal revenue, workers are also ideal

48 Bureau of Labor Statistics, *Unemployed persons by Duration of Employment*, February 1, 2019, https://www.bls.gov/news.release/empsit.t12.htm

representatives for the interests of taxpayers on corporate boards.[49]

Recommendation 2:
Ban Open-Market Stock Buybacks

The proposed ban on open-market buybacks would end a practice that has been used to extract value from public companies at the expense of workers, taxpayers, and retirement savers. Stock buybacks undermine capital formation needed to build sustainable and innovative companies. Research has shown that companies are decreasing their value over the long term by buying back too much stock. Retirement savers will pay the price in the form of a lower stock return, while short-term speculators will have cashed out in the days immediately following a buyback announcement. By creating constant downward pressure on wages, buybacks also restrict the ability of workers to contribute more of their wages to their retirement accounts over the course of their working career.

The buyback binge has led companies to borrow significantly—and at higher cost—in order to buy back still more stock. This dynamic has pushed corporate debt to record highs. The share-sellers reap short-term gains, yet they bear none of the risks of the other stakeholders, who are left to face the prospect of a default. Long-term retirement savers suffer the permanent loss of their investment if the company goes bankrupt. Workers face the loss of their job and pension cuts, possibly resulting in a delayed retirement. Taxpayers deal with further strain on public resources when they are used to assist workers who lose their jobs.

Recommendation 3: Take Legislative Action

The actions of the two most recent SEC Chairmen (appointees of both Democratic and Republican Presidents) make clear that the Commission will refrain from taking action unless required by Congress. Since Rule 10b-18's adoption, trillions have flowed through national stock exchanges out of public companies. The Commission has ignored Congressional requests to update its rules governing buybacks. It has refused requests to commit staff resources to studying the buyback phenomenon. It has even ignored the advice of one of its own Commissioners to address buybacks. The Commission's refusal to admit that its Rule 10b-18 has dramatically changed public-company behavior indicates that it will be unable to address the problem it has itself created.

49 Center on Budget and Policy Priorities, "Where Do Federal Tax Revenues Come From?", December 6, 2018, https://www.cbpp.org/sites/default/files/atoms/files/PolicyBasics_WhereDoFederalTaxRevsComeFrom_08-20-12.pdf

Conclusion

The Reward Work Act

The *Reward Work Act* incorporates the above recommendations by requiring all public companies to allow workers to directly elect one-third of the company's board of directors and by banning open-market stock buybacks. These two reforms will ensure that American companies are run for those who invest the most in the company's productive capabilities.

These contributors are workers—who invest time, skill, and effort; taxpayers—who supply the preconditions for business such as infrastructure to get products to market and education to improve labor productivity; and finally communities—which provide the ability for workers to live near their jobs, but more importantly, make life worth living.

The Reward Work Act will improve the way public companies are run to ensure that value creators are rewarded for their work while value extractors are not allowed to use their wealth to claim the profits that workers have created.

Acknowledgements:

This report would not be possible without the help of William Lazonick, Ken Jacobson, Erdem Sakinc, George Tyler, and many others. Thank you.

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