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Hearing on Legislative Proposals to Relieve the Red Tape Burden

on Investors and Job Creators

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Good morning, Chairman Garrett, and Ranking Member Maloney. I am Damon Silvers, and I am the Policy Director and Special Counsel of the AFL-CIO. In addition, I serve on the Office of Financial Research's Financial Research Advisory Committee, a body devoted to assessing systemic risk in the financial system; the Securities and Exchange Commission's Investor Advisory Committee; the Standing Advisory Group of the PCAOB; and I served as the Vice Chair of the Congressional Oversight Panel for TARP during the aftermath of the 2008 Financial Crisis. My testimony today though is solely on behalf of the AFL-CIO.

The AFL-CIO is a Federation of 57 member unions representing 12 million working people. Union members participate in benefit plans with over $4 trillion in assets, and unions and employers jointly sponsor retirement funds with over $550 billion in assets.

Since 1980, the United States has gone through several cycles of financial deregulation, followed by speculative bubbles. The first of these episodes led to the savings and loan fiasco of the early 1990's, the second to the tech bubble collapse in 2000 and the wave of corporate scandals and bankruptcies that began with Enron in 2001. And the third, and by far the most devastating, was the residential real estate bubble driven by a deregulated banking sector through the use of mortgage backed securities, and the subsequent collapse of that bubble starting in 2007. The Bank of England has estimated that the worldwide cost of the collapse of the most recent U.S. centered financial bubble is in excess of $60 trillion.[1]

Today, this Committee is considering a package of bills each of which is wrongheaded in its own peculiar way, and which taken as a package are a clear indication that the House of Representatives is actively seeking to initiate another round of financial deregulation. This effort is not limited to the bills under consideration today, but includes the recently passed JOBS Act, a number of bills designed to deregulate the over the counter derivatives business, bills designed to

[1] Andrew Haldane, *The $100 billion question*, Mar. 30, 2010 *available at* http://www.bis.org/review/r100406d.pdf?frames=0.

weaken the Consumer Financial Protection Bureau, and bills designed to repeal those portions of Dodd-Frank that address the problem of how to wind down "too big to fail" financial institutions.

Predictions are a dangerous business, but the recent history of financial markets strongly suggests that this legislative effort, should it prove successful, will seriously increase the risk of another cycle of financial bubble and bust, with serious implications for the larger U.S. economy.

I would now like to turn to the specifics of the bills before this subcommittee.

H.R. 1135, "The Burdensome Data Collection Relief Act"

H.R. 1135, the "Burdensome Data Collection Relief Act," seeks to keep secret the relationship between CEO pay and the median pay of other employees at public companies, by repealing section 953(b) of the Dodd-Frank Act, which requires such disclosure. The AFL-CIO strongly opposes H.R. 1135. It is a bill designed to hide material information from investors, encourage runaway CEO pay and increase economic inequality.

Despite the fact that the Dodd-Frank Act passed three years ago, the Securities and Exchange Commission has failed so far to carry out its statutory obligation to issue implementing rules for Section 953(b) of the Act. In the absence of the firm specific information required by the Act, Bloomberg News recently conducted a study comparing CEO pay to the pay of the average US worker in the same industry. Bloomberg found that the average CEO-to-worker pay ratio for S&P 500 companies is 204-to-1. The average ratio for the top 100 paid executives in the S&P 500 was 495-to-1.[2]

But the real numbers investors need are still completely secret. We live in a globalized environment. America's public companies employ people around the world, and the true nature of the disparities between CEO's and their employee teams would be revealed by Section 953(b).

And this is precisely the information investors need—company specific, company wide data. Why?

Investors have long had multiple concerns about CEO pay—starting with the raw numbers that come out of investors' pockets. Top executives at large public companies now keep for themselves an average of 10% of their companies' net profits, approximately double the rate in the early 1990s.[3]

CEO pay levels are currently often based on "peer group analysis" that has contributed to CEO pay inflation, by encouraging the "all CEO's are above average" phenomenon. CEO-to-worker

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[2] Elliot Blair Smith and Phil Kuntz, *Disclosed: The pay gap between CEOs and Employees*, Bloomberg Businessweek (May 2, 2013) *available at* http://www.businessweek.com/articles/2013-05-02/disclosed-the-pay-gap-between-ceos-and-employees

[3] Lucian Bebchuk and Yaniv Grinstein, The Growth of Executive Pay, Oxford Review of Economic Policy, Vol 21 (2005).

pay ratio disclosure will enable investors and boards to also consider the relationship of CEO pay to other company employees.

But CEO pay disclosure is about much more than the raw wealth transfer. CEO pay in relation to compensation throughout the firm is a key indicator of the quality of the firm's culture and management. Jim Collins, author of the international bestselling book *Good to Great*, conducted an exhaustive survey to identify companies that are truly "great." "Great" companies were defined as those which generated, over fifteen years, cumulative stock returns that exceeded the market by at least three times. Of the nearly 1,500 companies that Collins surveyed, not one of the "great" companies had a high-paid, celebrity CEO.[4] Such celebrity CEOs turn a company into "one genius with 1,000 helpers," taking focus away from the motivation and creativity needed from all of a company's employees.[5]

Organizations with a high disparity of pay between top paid employees and lower paid workers suffer a decline in employee morale and commitment to the organization.[6] Extreme disparities between CEO and employee pay produce significant deterioration in the quality of products produced by employees.[7] Strongly disproportionate CEO compensation compared to other employees results in higher employee turnover and lower job satisfaction.[8] Finally, firms with high levels of CEO pay relative to other top executives have reduced performance.[9]

Section 953(b) gives investors and boards the data they need to act on the insight of the late management theorist Peter Drucker, who thought "excessively high multiples undermine teamwork and promote a winner-takes-all, 'did-it-because-I-could' culture that's poison to a company's long-term health." And his idea of excessively high was more than 25-1.[10]

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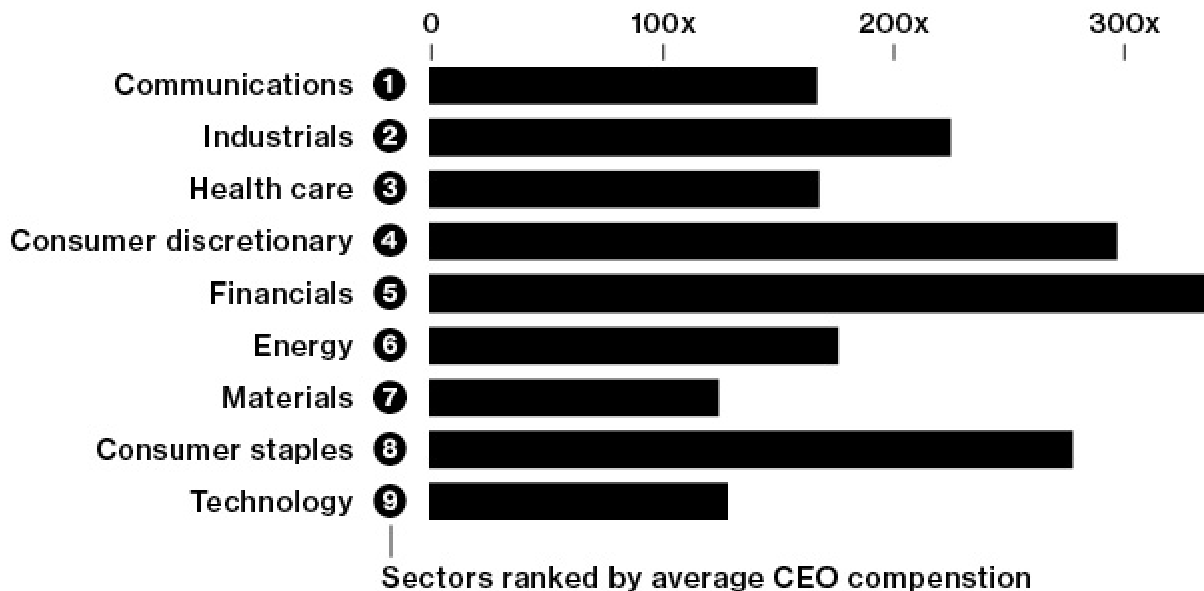
[4] Jim Collins, Good to Great: Why Some Companies Make the Leap . . . and Others Don't, (HarperBusiness, 2001).
[5] Interview with Jim Collins, Great Answers to Good Questions, Fast Company, August 31, 2001.
[6] See e.g. Jeffrey Pfeffer, Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained, Journal of Economic Perspectives, Vol. 21 (2007).
[7] Douglas Cowherd and David Levine,Product Quality and Pay Equity Between Lower-Level Employees and Top Management, Administrative Science Quarterly, Vol. 37 (1992).
[8] Matt Bloom and John Michel, The Relationships Among Organizational Context, Pay Dispersion, and Managerial Turnover, Academy of Management Journal, (2002). See also James Wade, Charles O'Reilly III, and Timothy Pollock, Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation, Organization Science (2006), finding the same effects stretching down at least five levels down the chain of command.
[9] Lucian Bebchuk, Martijn Cremers, and Urs Peyer, The CEO Pay Slice, September 2010, Journal of Financial Economics.
[10] Elliot Blair Smith and Phil Kuntz, *Disclosed: The pay gap between CEOs and Employees*, Bloomberg Businessweek (May 2, 2013) *available at* http://www.businessweek.com/articles/2013-05-02/disclosed-the-pay-gap-between-ceos-and-employees



<u>H.R. 1105, "The Small Business Capital Access and Job Preservation Act."</u>

This Act has nothing to do with small business and everything to do with ensuring some of the richest and most powerful, and most tax subsidized, Wall Street firms are allowed to continue to operate, and build up system-wide leverage, in secret.

H.R. 1105 would exempt all private equity fund advisers from the registration and reporting requirements in the Dodd-Frank Act, unless each fund has outstanding borrowings that exceed two times the fund's invested capital commitments.

This would be a bad idea even if this bill meant what it appears to mean. But it has embedded in it two fundamentally misleading concepts. The first is the very idea of a "private equity fund." There is no fundamental legal distinction between private equity funds, hedge funds and venture capital funds. These are terms that describe broad investment strategies, not legal structures. So the bill directs the SEC to define what a private equity fund is. And there is no telling how broad or narrow, or gameable, such a definition will be. So if Congress enacts this bill, it will be potentially opening a loophole in the hedge fund registration requirement big enough for every hedge fund billionaire in Greenwich willing to pay a lawyer to drive through.

Then there is the leverage limitation. This limitation is also an illusion, clearly drafted in bad faith, because it applies to leverage at the fund level, and only to "private equity funds." Investment partnerships that pursue private equity strategies—which is public relations code for leveraged buyouts rarely utilize debt at the fund level. The vast majority of borrowing in private equity transactions occurs at the portfolio company level, in their operating subsidiaries, not at the fund level.[11] Often advisers are subject to explicit contractual limitations on leverage at the fund level that are agreed to with tax-exempt investors to allow them to avoid paying "unrelated business income tax" (UBIT).[12]

Investment partnerships that pursue hedge fund strategies typically incur debt at the fund level, which is why the SEC's current definition of a hedge fund includes all investment partnerships that incur significant debt.

The impact of this bill would be to prevent the SEC from collecting the information necessary to monitor a significant source of systemic risk. Section 404 of the Dodd-Frank Act gave the SEC authority to establish recordkeeping and reporting requirements "as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council." H.R. 1105 would exempt private equity funds from this recordkeeping and reporting framework and direct the Commission to replace it with one that omits consideration of potential systemic risks and is exclusively for use by the Commission. The Commission has already finalized a disclosure regime for private funds as was required by Title IV of Dodd-Frank.[13] The disclosure requirements distinguish among funds by type and size. The frequency and content of reporting vary depending on these factors.

An appropriate examination of the potential systemic risks associated with leveraged buyout activities must consider the financial system's exposure to leveraged buyout debt from the perspective of the leveraged buyout fund that controls the entities that have incurred the debt. According to the Financial Times, "covenant-lite loans that strip out safeguards for investors,

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[11] "A significant source of capital for venture capital and other private equity funds is pension plans, individual retirement accounts, foundations, and endowments. These are all tax-exempt entities under the Internal Revenue Code. Tax-exempt organizations, including "qualified" pension plans, individual retirement accounts, foundations, and endowments, are subject to "unrelated business income tax" (UBIT) on their "unrelated business taxable income," often referred to as UBTI. In connection with their investments in private investment funds, many tax-exempt investors seek to avoid or limit the funds' generation of UBTI.
Fund sponsors commonly accommodate tax-exempt entities by covenanting not to incur, or to limit or minimize, UBTI. Practically speaking, a covenant to avoid UBTI means that the fund cannot incur indebtedness and cannot invest in flow-through operating entities, except through "blocker" structures." Accommodating Tax-Exempt Investors: Understanding UBTI, Morgan Lewis *available at* http://www.morganlewis.com/documents/VCPEFdeskbook/VCPEFdeskbook_AccommodatingTaxExemptInvestors.pdf

[12] *Id.*

[13] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 221, 71127 (Nov. 16, 2011) (to be codified at 17 C.F.R. pts. 275 & 279).

dividend deals in private equity-controlled companies, and a third class of instruments, payment-in-kind toggle notes, were widely criticized as part of the easy lending that led to the credit crunch."[14]

Earlier this month, *CNNMoney* reported, in an article entitled, "Waiting for the bond bubble to pop," that junk bond yields are at their lowest point in history and that "[l]enders are not only doling out lower rates but in the case of refinancing, they're also willing to let companies skip out on most covenants that attach strings to how much a company must earn to stay up to date with these loans."[15] According to the article, covenant lite loans "are nearing levels last seen during the financial crisis."[16] This is cause for particular concern in light of Moody's analysis that "the relatively swift recovery of debt markets following the credit crisis masked the true risk of covenant-lite loans.... In a more prolonged credit downturn, companies with lenient covenant terms would be more likely to default, and their lenders would likely recover less than would investors in defaulted companies with more restrictive covenants."[17]

Finally, H.R. 1105 would deny investors in private equity funds, including workers' pension funds, the protections of investing with a registered investment adviser. Registered investment advisers are required to file a "Form ADV" with the SEC and update it on an annual basis. The Form ADV has two parts. Part I includes information about an adviser's business, the persons who own or control the adviser, and whether the adviser or certain of its personnel have been sanctioned for violating the securities laws or other laws. This is available to the public online. Part II is a written disclosure statement that provides information about business practices, fees, and conflicts of interest the adviser may have with its clients. This must be provided to clients and potential clients of the fund and is not available to the public.

H.R. 1105 is a bill that would increase systemic risk, weaken investor protections, and offer regulatory subsidies to a portion of Wall Street that is already the beneficiary of inexcusable tax subsidies. It is legislation written not for the top 1%, but for the top 1/100 of one percent. And it is drafted in a manner aimed at misleading members of the House into thinking the bill has meaningful protections against excessive leverage when it does not. For all these reasons the AFL-CIO strongly opposes H.R. 1105.

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[14] Nicole Bullock, *Risky loans stage comeback*, FT (March 13, 2011), *available at* http://www.ft.com/cms/s/0/9f7c528c-4da3-11e0-85e4-00144feab49a.html#ixzz1GchehYL7.

[15] Maureen Farrell, *Waiting for the bond bubble to pop*, CNNMoney (May 3,2013) *available at* http://money.cnn.com/2013/05/03/investing/bond-bubble/index.html

[16] *Id.*

[17] Moody's Investor Services, Announcement: Moody's: Covenant-Lite May Lead to Larger Investor Losses in Next Credit Downturn, Moody's Global Credit Research (March 10, 2011), *announcement available at* http://www.moodys.com/viewresearchdoc.aspx?lang=en&cy=global&docid=PR_215517.

Draft Legislation to Amend Section 913 of the Dodd-Frank Act

This bill is designed to place a number of unusual procedural obstacles in the way of the Securities and Exchange Commission by changing the standard of conduct that is applied to broker-dealers' treatment of their clients. This bill must be understood against the backdrop of recent enforcement actions by the Commission against broker-dealers for violating the current standards of broker-dealer conduct, and the defenses mounted by broker-dealers to these actions. Many investors, particularly less sophisticated retail investors, might be surprised to learn that brokers have no legal duty to give investors advice that is actually in the client's interest. They merely have a duty to ensure that the securities they recommend are "suitable" for the client. By contrast, investment advisors have a fiduciary duty to act in their client's interest. This distinction got a fair amount of public attention in the context of the Commission's case against Goldman Sachs for selling credit default swaps to clients without telling them the swaps had been designed by the party on the other side of the transaction. In a sense, this bill is designed to facilitate Goldman Sachs continuing treatment of its less favored clients as feedstock for its more favored clients.

The draft bill would require the Commission, before promulgating a rule changing the nature of brokers' duties to their clients, to identify whether the different standards of conduct that apply to broker-dealers and investment advisers result in harm to retail investors. In addition, the bill requires the Commission's Chief Economist to conduct a cost benefit analysis of such a change, make a formal finding that the rule would reduce investor confusion, and coordinate with other federal regulators. Finally, the bill would prohibit the SEC from proposing rules applicable to broker-dealers' standard of conduct without simultaneously proposing rules that would "address any harm to retail customers resulting from differences in the registration, supervision, and examination requirements applicable to brokers, dealers, and investment advisers.''

Obviously these unusual requirements are designed to slow down and make procedurally burdensome any effort to strengthen investor protections vis a vis broker dealers. But the procedures envisioned in this bill have a more devious purpose as well—they are designed to generate multiple excuses for the Federal Appeals Court for the DC Circuit, which has long ago abandoned any notion of deference to regulatory agencies, to overturn any rules they wish.

The coordination section of the bill is particularly peculiar. It requires coordination with other federal agencies, but not with state securities regulators. This is odd because state securities regulators have shared responsibilities to regulate broker-dealers with the Securities and Exchange Commission, and no federal regulator has such responsibilities. This language would appear to be a backdoor effort on the part of the sponsors of this legislation to constrain the U.S. Department of Labor, which has parallel responsibilities for regulating ERISA fiduciaries, but not shared responsibility for broker-dealers.

This bill comes at a time when the SEC has been reviewing its regulation of broker-dealers. The SEC is currently in the process of collecting data to support an economic analysis of a new fiduciary duty rule to help it determine whether new regulations are necessary and how to best structure new regulations if deemed appropriate. The SEC has already conducted extensive analysis of the nature that would be required by this bill, including the 2008 Rand study and the study required under Section 913 of Dodd-Frank.

Meanwhile, the case for a unified regulatory regime covering both broker-dealers and investment advisors keeps building. In its 2008 study for the Commission, the Rand Corporation found that, "the evolution of the financial service industry has blurred traditional distinctions between broker-dealers and investment advisers and made it difficult to design appropriate regulatory schemes for their professional services."[18] Investors are confused by the differing standard of care between broker-dealers and investment advisers and many investors assume that both are required to act in investors' best interest.[19]

The SEC should be free to improve investor protections in relation to broker-dealers without having to deal with special procedures designed to paralyze the Commission in its pursuit of its mission. Consequently, the AFL-CIO strongly opposes this bill.

H.R. 1564, "The Auditor Integrity and Job Protection Act,"

H.R. 1564 seeks to prevent the Public Company Accounting Oversight Board (PCAOB) from placing limits on the length of time a public company can use the same audit firm, referred to as auditor rotation. H.R. 1564 amends Sarbanes-Oxley by adding a limitation on PCAOB authority which states, "The Board shall have no authority under this title to require that audits conducted for a particular issuer in accordance with the standards set forth under this section be conducted by specific auditors, or that such audits be conducted for an issuer by different auditors on a rotating basis."

H.R. 1564 both substantively weakens the ability of the PCAOB to play its role in protecting our economy against systemic risk, and it weakens the independence of auditor regulation. Both results are contrary to the public interest, and consequently the AFL-CIO opposes this bill.

The AFL-CIO has a long-standing position in support of mandatory audit firm rotation. A new audit firm brings a fresh perspective and, often fresh skepticism, that may be missing when an auditor has a long-standing relationship with the firm. Longtime auditors may come to believe they understand the totality of the client's issues, and may look for those issues in the next audit

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[18] Angela A. Hung, et. al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2008) *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf

[19] SEC, Study on Investment Advisers and Broker-Dealers as Required By Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2011) *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf

rather than staying open to other possibilities. Auditors tend to rely on prior years' working papers, including prior tests of the client's internal control structure, particularly if fees are a concern. Finally, when an audit firm has the opportunity to retain their position with, and income from, an individual client indefinitely, there may be an incentive to avoid escalating problems identified during the audit process out of fear of angering the client and losing its business. Mandatory auditor rotation could mitigate this possibility by requiring that potential income from the client could not flow indefinitely.

Currently, regulators with inspection authority, both here and abroad, have expressed widespread concern over the consistent failures they are seeing by auditors to remain independent of their clients. Currently, Congress does not have access to PCAOB inspection reports. As such, at a minimum, Congress should add itself to those groups with whom the PCAOB can share its inspection results. Congress could then consider these findings for themselves before they choose to have the federal government get in the business of writing accounting and auditing standards.

The issues raised by this bill are however, more complex than those raised by the other bills the subcommittee is considering today, as a result of the oligopolistic market for audit services. Since the collapse of Arthur Anderson in early 2002 there are only four global audit firms that are plausible auditors for large global businesses. Some have observed that auditor rotation may not be practical in a world of only four major global audit firms. Our view is that the opposite is true, that after more than ten years have passed since the collapse of Anderson, there is no sign of any new viable entrants into this market, and many signs that the lack of competition for audit firms has contributed to audit firms not asking the tough questions that might have given us better early warning over the financial crisis that began in 2007. Against this background, mandatory audit firm rotation may be the only effective tool regulators possess to encourage real competition in the audit of large capitalization public companies. In this respect, I would call the Subcommittee's attention to the work of the Bush Administration's Treasury Department's Committee on the Future of the Auditing Profession.[20]

But ultimately, whether audit firm rotation is or is not the right solution, the decision should be left with the PCAOB, the independent public company auditor regulator created by Congress in the Sarbanes-Oxley Act. H.R. 1564 seeks to place Congress in the position of the independent regulator. This approach is unlikely to yield a better substantive outcome, and if followed through upon, would fundamentally weaken the PCAOB not just in this area, but in all areas, and do so just at the time when the PCAOB is pursuing its mission with renewed vigor and independence.

[20] Advisory Committee on the Auditing Profession Final Report, Oct. 5, 2008 *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.

Conclusion

There is an urgent unfinished financial regulatory agenda—it includes completing the Dodd-Frank rulemaking process, really taking on the problem of the too big to fail institutions as Senators Brown and Vitter are attempting to do, and fairly taxing the financial sector, starting with ending the carried interest loophole and enacting a Financial Transaction Tax.[21]

But the bills today's hearing addresses are all headed in the opposite direction. They seek to undo, overtly or covertly, much needed reforms enacted in the Sarbanes-Oxley Act and the Dodd-Frank Act. Along with other deregulatory bills enacted or in process in this Congress, these bills seem designed to increase systemic risk, increase economic inequality, and decrease investor protections.

We know where this type of policymaking leads. It leads to bubbles and collapses, to financial instability and to mass unemployment. And after the party is over, workers will once again be presented with the bill in the form of lost retirement savings, falling wages, job loss, and reductions in public services.

The AFL-CIO hopes this Subcommittee will instead move away from yet another indulgence in the delusions of deregulation, and focus on how to strengthen our statutory and regulatory protections against systemic risk and the exploitation of investors.

On behalf of the AFL-CIO, I wish to again thank the Subcommittee for the opportunity to appear to discuss these vital issues, and I look forward to your questions.

[21] S. 410, H.R. 880, 113th Cong. (2013).