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Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

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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

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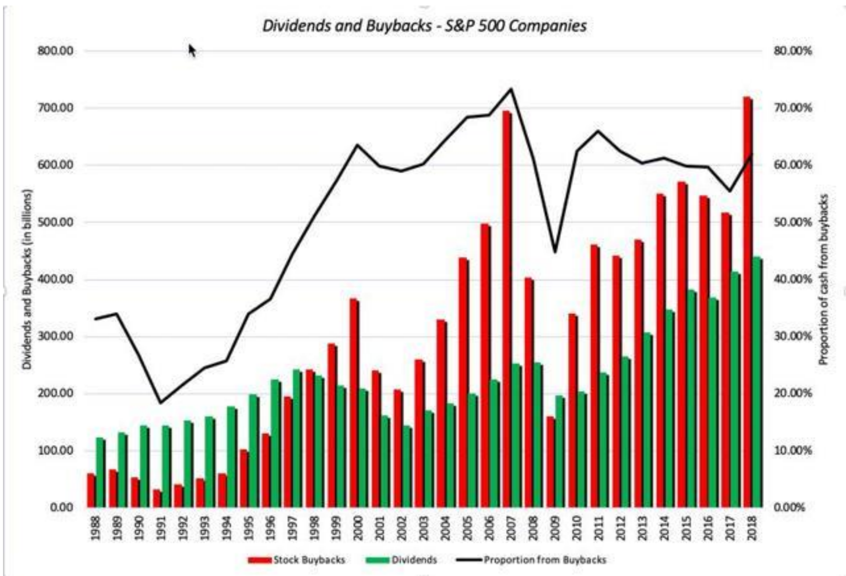
[4] "$2.6 Trillion Investor Coalition Sees Link Between Human Capital Management and Shareholder Return" Engagement Strategies Media. Available at: http://www.enterpriseengagement.org/articles/content/8472962/26-trillion-investor-coalition-sees-link-between-human-capital-management-and-shareholder-return/.

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.

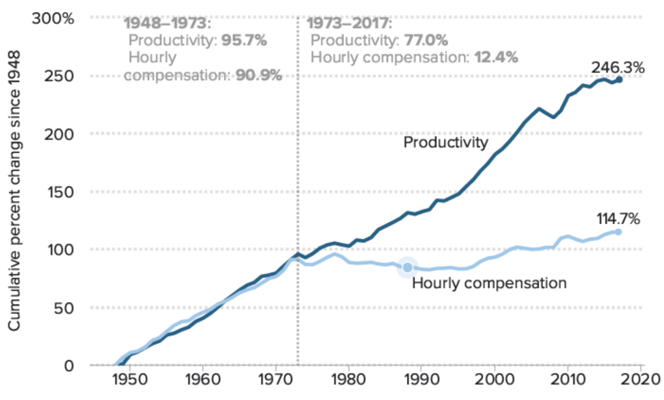
Today, the Subcommittee considers a draft bill "to study whether to amend the rules of the Commission relating to certain stock repurchases." In my view, the basic facts are already clear, and it is time for action.[11] Congress must pass legislation to affirmatively address stock buybacks before companies 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)

[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

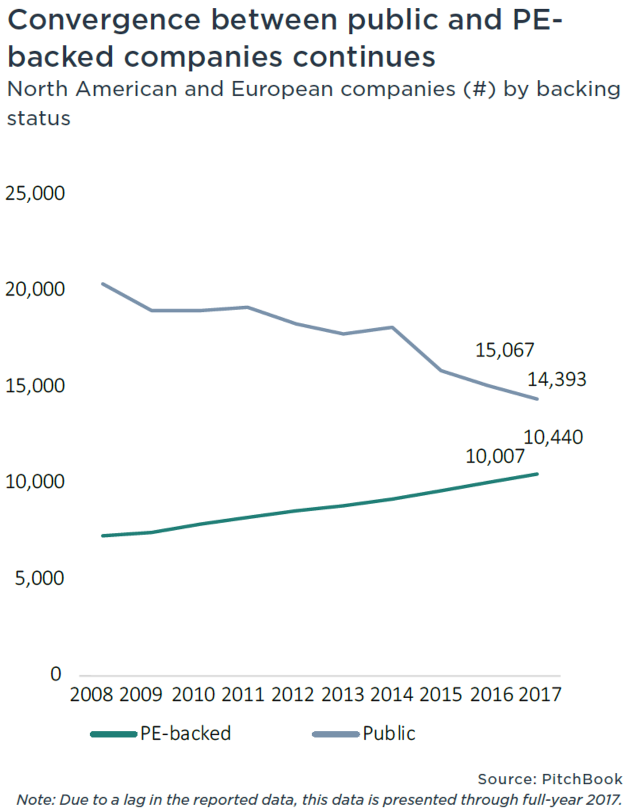
[12] Lenore Palladino, *Why Workers On Corporate Boards Just Makes Sense*, RooseveltInstitute.org: Published in Blog, Economic Inclusion, Economy & Growth, Work and Labor, Aug. 14, 2018 *available at* https://rooseveltinstitute.org/why-workers-corporate-boards-just-makes-sense/

[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.



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

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[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.
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[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]

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[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…
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> [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.

[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.