SHORT-TERMISM IN FINANCIAL MARKETS

HEARING
BEFORE THE
SUBCOMMITTEE ON
ECONOMIC POLICY
OF THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED ELEVENTH CONGRESS
SECOND SESSION
ON
EXAMINING SHORT-TERMISM IN FINANCIAL MARKETS

APRIL 29, 2010

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SHORT-TERMISM IN FINANCIAL MARKETS

THURSDAY, APRIL 29, 2010

U.S. SENATE,
SUBCOMMITTEE ON ECONOMIC POLICY,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:05 a.m., in room SD–538, Dirksen Senate Office Building, Senator Sherrod Brown (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. Welcome. The hearing of the Subcommittee on Economic Policy of the Senate Banking Committee will come to order. Thank you, panelists, for joining us. I know each of you is extraordinarily busy, and several of you had to rearrange schedules to be here, and I appreciate that very much.

In an age of BlackBerrys and instant messaging and videoconferencing, we have become used to shrinking the distance between Points A and B, whether the goal is to gather information or resolve a problem or exploit an opportunity. What was once considered expeditious is now more or less considered the norm.

In that same vein, there is a familiar business impulse—and Government impulse, frankly—to generate short-term results no matter what the long-term cost. This is a subject, short-termism, that we are considering this morning. It is a timely subject given that by hook or crook the Senate will reform Wall Street and will do it soon.

One thing we have or should have learned from the events that led to our current situation is that if Wall Street wheeler dealers become blindly obsessed with short-term gains, their actions can potentially—and have—shatter the economic security of Americans and the Nation in which we live.

Over the past year, I have chaired several hearings in this Subcommittee to examine the opportunities and the challenges facing American manufacturing. Chief among these challenges is the obsession with quarterly results, the short-term expectations from the world of finance, which too often sacrifice long-term economic growth and job creation. Short-termism involves a tradeoff between long-term productivity and fast cash. Financial transactions supplement manufacturing as a means of growing the economy at the expense of our Nation’s self-sufficiency—our ability to make the products we need, generate the energy we use, equip the armed forces upon which we all rely.
Recent trends have transformed quarterly earnings into benchmarks for speculators to make bets. The rise of private equity and hedge funds has deepened that volatility.

A couple years ago, the middle-class community of Tiffin, Ohio, a small town in northwest Ohio, experienced economic hardships that result when a short-term approach drives decisions. Tiffin was home to American Standard, the kitchen and bathroom fixture manufacturer whose products likely grace the home of many of you today. In late 2007, American Standard was bought by Bain Capital in cash. Bain then liquidated the assets, moved jobs offshore, and sold the controlling stake in the firm to another private equity firm. More than 200 manufacturing jobs in Tiffin were eliminated—without warn notices, I might add—and the community was left with an empty plant of a longstanding, prestigious company.

Last week, we avoided a similar situation in northeast Ohio when Hugo Boss, the German company, clothing manufacturer, made a decision to keep its last suit manufacturing plant open in Brooklyn, Ohio. Hugo Boss had, as I said, just this one plant left in the United States. But the situation with Hugo Boss and the private equity firm that has a controlling stake in its company raised several questions about short-termism and the ripple effects of a plant closing decision.

This is just one example that illustrates the emphasis past Administrations and Congresses and the corporate titans of this country have placed on financial services at the expense and gross neglect of American manufacturing.

Thirty years ago, manufacturing made up 25 percent of GDP; manufacturing was one-quarter—slightly more than one-quarter of our GDP; financial services made up less than half that, about 11 percent. By 2004, it had pretty much flipped. Manufacturing accounted for just 12 percent of our economy while financial services were 21 percent.

In 2004, the financial industry accounted for 44 percent of all domestic profits. In 2010, even after a year-and-a-half of busts and bailouts, manufacturing—or, I am sorry, the financial industry accounts for more than 35 percent of corporate profits. So when people in the Administration or out of the Administration tell us that our Government should not pick winners, manufacturing, the answer is we already have the last three decades.

We can see the effects of short-termism as we work on Wall Street reform today. Just look at the oversupply of toxic assets that clogged our credit markets. Too many mortgage lenders were so focused on booking revenue from loan transactions, they paid too little attention to true risks. Too many lenders actually encouraged borrowers to take on larger mortgages than they act could afford. We know that. Why? Those lenders earned a quick buck. This problem was made worse by bundling these mortgages into big packages, mortgage-backed securities, and selling them off to other investors, leaving aside the rating agencies and their role in this.

In putting Wall Street aside, the problem was—putting Wall Street aside, there are some promising developments when it comes to risks and costs of short-termism. Fortunately, more and more large businesses recognize the problems caused by this myo-
pia, if you will. Over the past few years, more corporate executives, more CEOs have done soul searching and more publicly traded companies are not playing the quarterly earnings game. Groups like the Business Roundtable and some of our best business schools are taking a critical look at the short-term business model. But if quarterly earning reports were to completely disappear as the primary metric of evaluating businesses, what replaces them? What is the appropriate measure of long-term value?

I hope our witnesses today can think about this, offer their thoughts on this and other questions about this myopic sort of short-termism today. I thank our witnesses for joining us. I look forward to their statements. I will introduce each of you, then begin with Mr. Rogers, and you are to speak, you know, 5, 6, 7 minutes. Certainly you do not have to keep it right at 5 minutes.

Jim Rogers is chairman of the board, president, and chief executive officer of Duke Energy. Mr. Rogers has more than 21 years of experience as a CEO in the electric utility industry. He was named president and CEO of Duke following the merger of Duke Energy and Cinergy in Cincinnati in April 2006.

Damon Silvers was the Chair of the Competition Subcommittee of the United States Treasury Department Advisory Committee on the Auditing Profession and a member of the Treasury Department Investor’s Practices Committee of the President’s Working Group on Financial Markets. Prior to working for the AFL-CIO, Mr. Silvers was a law clerk at the Delaware Court of Chancery for Chancellor William Allen and Vice Chancellor Bernard Balick.

Judith Samuelson is founder and Executive Director of the Business and Society Program at The Aspen Institute. Founded in 1998, the program employs dialog, teaching, and research to explore complex issues at the intersection of business and society. Ms. Samuelson’s work experience spans the business, government, and nonprofit sectors. She joined the Ford Foundation in 1989 and served through 1996 as Director of the Office of Program-Related Investments.

Professor J.W. Verret received his JD and MA in Public Policy from Harvard Law School and the Harvard Kennedy School of Government in 2006. While in law school, he served an Olin Fellowship in Law and Economics at the Harvard Program on Corporate Governance. Prior to joining the faculty at Mason Law, Professor Verret was an associate in the SEC Enforcement Defense Practice Group at Skadden, Arps in Washington, DC, and he has written extensively on corporate law topics.

I switched the order of the middle two of you, but I will go left to right. So, Mr. Rogers, if you would begin, thank you.

STATEMENT OF JAMES E. ROGERS, CHAIRMAN, CHIEF EXECUTIVE OFFICER, AND PRESIDENT, DUKE ENERGY CORPORATION

Mr. Rogers, Thank you. Mr. Chairman, I am delighted to be here today, and I want to thank you for holding this hearing and focusing on the importance of having a long-term perspective in our capital markets and focusing on what I would call cathedral thinking.
Our industry is the cornerstone of the economy. We enable everyday living. We enable the growth of the economy, and if you think back to the 20th century, what was enabled by our deployment of capital in providing universal access to electricity in America. We are the most capital-intensive industry in the U.S. Job one for me is affordable, reliable, clean electricity 24/7/365, and to get that job done, I have to attract capital. I have to deploy capital in this most capital-intensive industry. But said another way, my job is to bring capital to and create public policy solutions that are created by Congress. As Congress addresses energy and environmental issues, it is our job to attract the capital, to deploy the capital, and to carry out the mission of energy and environmental legislation in this country.

Today, as an example, we are stimulating the economy, creating jobs, and cleaning up the air. We are building a number of plants—two coal plants, two gas plants, renewables, smart grid in Ohio. We have in the southern part of Ohio a clean park there where we could deploy up to $12 billion and create jobs in one of the counties where the unemployment is the highest in the State. But just with our building program today, we are employing over 6,000 people in the middle of this recession. Once we complete these plants, the jobs there will be the type of jobs that will rebuild the middle class in America, create a tax base which will fund the schools in each of these counties where we are building new plants.

So we are by 2050 have to modernize our entire fleet. We have to modernize our transmission and distribution, and we need to attract patient capital to get that done.

So we need investors with a long-term view. I have been part of the Aspen Institute and worked with Judy and really applaud what they have done because they have really led the way in thinking about these issues and trying to put in place a framework that will really encourage investors to take a long-term view.

From our company’s perspective and in a broader sense from our industry’s perspective, the dividend is really key. Very few companies pay dividends as high as ours. For instance, we pay out to our investors $1.3 billion a year, and the large part of our investors are retail investors. So they own our stock, and a lot of them are retired, and with more and more people retiring, with the baby boomers coming of age—a much older age, I might add, speaking as one—our stock is very attractive to them because of the dividend. But we need to attract capital even beyond, and we need to incent people to own dividend-paying stocks.

So one idea that I would suggest to encourage holding our stock for long periods is really to tie the tax rate on dividends to how long you have held the stock. So the longer you hold the stock, the lower the tax rate on a dividend. So that would really encourage people to not just buy our stock, but to hold our stock over a very long period. And if you juxtapose that with the number of people retiring and living much longer than our parents or our grandparents did and the need to be able to subsidize Social Security, to augment 401(k) plans, a dividend-paying stock like ours does that.

And so another way to think about this from a public policy perspective, this just is not about attracting capital to carry out the
U.S. policy on energy and environmental issues; it is also about addressing the growing concern in this country with respect to the viability of Social Security and augmenting the earnings of our people over the next 10 to 30 years. At the same time, we really need to attract the capital to modernize our entire system and specifically our generation.

Let me conclude my comments by spending a moment on cathedral thinking. You were right in your opening comments when you talked about we are really focused on the short term, and certainly we are under tremendous pressure to produce quarterly earnings. I know that very well because I am working on my earnings call for next week. And people look not just quarterly but annually, but we think in terms of decades.

Take a nuclear plant. It takes us almost 10 years to build a nuclear plant. It takes 5 years to build a coal plant. You are deploying $5 billion, $12 billion. And we are building plants whether they are renewables—and we are one of the largest wind generators in the country, or solar like our program in North Carolina “solar on the rooftop.” Whether it is coal, whether it is gas, whether it is nuclear, all these facilities are going to last 30, 40, 50 years.

So when I think about the future, cathedral thinking has got to be at the heart of what I think. And let me share with you what that means, because our country has forgotten it.

If you go to Europe and you look at the great cathedrals of Europe, you recognize that they were built over 100 years, most of them. And at that time, given the life span of people, you are looking at three to four generations to build a cathedral. And so the people that worked on the foundations never saw the windows or the stained glass windows. Those that worked on the stained glass windows never saw the spires. The architect never saw it finished. And yet every generation they committed their time, their energy, their passion to getting it done.

They did it because they had a vision. They did it because they believed in tomorrow. They did it for their children and for their grandchildren. And yet they never really saw it finished. They never saw all those things that have happened over the last 400, 500, 600 years in those cathedrals with respect to the lives of people that came after them. But they did it because they had this vision and faith in the future. And what we really need to do is structure policy, financial policy in this country that encourages people to have this cathedral thinking, because that is the only way in the manufacturing sector and the utilities sector that we have the ability to really rebuild the infrastructure of our country, rebuild the manufacturing sector in our country. We have to have that cathedral thinking. And in my judgment, if we do, we will make the tough decisions, and we will have the capability to attract the capital.

In closing, I would simply say we need cathedral thinking, but we need to act in China time, and then the combination of the two will allow our country to get our mojo back. And now more than ever we need it.

Thank you, sir.

Chairman BROWN. Thank you. Cathedral thinking, China time, get our mojo back. That was a quite interesting last paragraph.
Chairman Brown. Ms. Samuelson, thank you for joining us.

STATEMENT OF JUDITH F. SAMUELSON, EXECUTIVE DIRECTOR, BUSINESS AND SOCIETY PROGRAM, ASPEN INSTITUTE

Ms. Samuelson. Thank you. Good morning and thanks again. I want to add my thanks for——

Chairman Brown. Is your microphone on?

Ms. Samuelson. Can you hear me?

Chairman Brown. No. Did you push the button?

Ms. Samuelson. Is it on?

Chairman Brown. Yes, that works.

Ms. Samuelson. Good. Thanks for doing this. We think it is an important topic, obviously, and we are delighted to be a part of this.

At the Business and Society Program at the Aspen Institute, our work is largely about working through dialog and through business education to align business with the long-term health of society. And, frankly, we have come to think it is all about timeframe. It is also about balance and judgment and vision, and it is about kind of recognizing that the results we have now are a result of this is the way the system is currently designed; and if we are going to have a different result, we are going to have to redesign the system.

The ideas that we are presenting today come out of a dialog that began in 2003 but has literally engaged hundreds of people since then. And I might just start with the definition of what we think about market short-termism.

If the common definition of sustainable development is to meet the needs of the present without compromising the ability of future generations to meet their own needs, then I think of short-termism as being kind of the antithesis of that. It is about making decisions to meet some benchmark today without regard for the needs of, or the costs imposed on, the future. Most often, the metrics employed are return on equity and share price, which fail to capture the most complex impacts of business that play out over the long haul.

A significant stream of academic literature engages this question. Some of it points to the consequence of excessive focus on earnings per share or on perhaps the response to a large block of short-term holders, with the response being that a firm will cancel value-creating investments. One survey of 400 CFOs suggests that up to 80 percent will cut discretionary spending—for R&D, for maintenance, for advertising—in order to avoid missing a quarterly forecast. And then a complementary study that came out of GW Law found that between 2004 and 2007, more than half of the S&P 500 spent more money on stock buy-backs than they did on productive investments.

The reason we do this work is because we are big believers in the extraordinary capacities of business. Another reason would be to avoid the kind of crises we have been seeing. But the reason we started this work in 2003 is because of the remarkable reach and distribution systems that business represents, research and management talent, and problem-solving skills. It is simply hard for us to imagine solving our most important problems domestically or internationally—whether we are talking about unemployment, pov-
The productive capacities of business are complex and real, and they naturally think long term in the way that Jim has just described. But it is also true that finance and financial services, as you have been speaking to, now command a much bigger portion of the GDP, and that the average holding period of stock continues to fall and that corporate managers often focus on short-term performance because that is what many of their most powerful investors want them to do.

Indra Nooyi, CEO of PepsiCo, who is one of our signatories, in a speech recently given at the Economic Club of Chicago captured it: Attention spans are short, time is money, and there is a premium on speed. At Pepsi, they are working on rewarding what she calls sustainable performance, and in this vein, in 2007 we released a set of guiding principles for business practice. They speak to having the right metrics to begin with, which we could potentially talk more about this morning, about stopping the practice of providing quarterly earnings forecasts, and also, of course, about long-term orientation in executive compensation.

Six courageous companies actually signed on to that document, including the one to my right and Pepsi and Pfizer and Apache, Office Depot, and Xerox. But there is also much more that can be done within the control of managers and boards.

But 2 years later, we turn to the question of policy. In September 2009, a working group finished the task of recommending public policy changes that would support the actions of these companies that are trying to stay long and focus attention on “shareholder short-termism.” In brief, they believe that with all of this discussion about investor rights also comes a question of investor responsibility.

The principal recommendation of that working group, which has now been endorsed by 30 leaders from business and investment and labor in a widely circulated Call to Action, is to create market incentives that reward long-term investment. Jim gave one example of how this might be achieved. The group talked about an excise tax on trading or perhaps by skewing the capital gains tax to greatly favor long-term holdings. Individual signers have proposed things like moving the cap gains tax to 0 percent after 10 years, with a high tax at the short end of the investor continuum, which could be a revenue generator or be revenue neutral, depending on how it is designed.

The drafters that participated in this policy release did not offer specifics, except to say that nontaxable entities, like pension funds, public pensions, also needed consideration, which might suggest some kind of modification to ERISA.

Other recommendations in this Call to Action address the need for better definition of fiduciary duty, as it applies to financial intermediaries and also better disclosure to illuminate the borrowing and lending of shares and to make the actual position—short or long—of large holders transparent.
The range of signatories behind these ideas and recommendations defies the usual alliances. Warren Buffett signed, but so did Richard Trumka of the AFL–CIO. Long-time investors like Peter Peterson and John Bogle, Lester Crown, Jim Crown, and Jim Wolfensohn signed on, as well as Steve Denning, who is the current head of General Atlantic Partners, a $15 billion private equity fund. The former CEOs of IBM, Cummins Engine, Medtronic signed, as did the current CEOs of Alcoa, Duke Energy, and TIAA–CREF.

I want to just also say a word about the business schools since you mentioned it.

Last year, some 150,000 students graduated from this country’s MBA programs, which is roughly the same number as sought teaching credentials. It far out-paced professional degrees in law, medicine, and engineering. Twice that many are choosing undergraduate majors in business, economics, and commerce each year—challenging both the colleges and universities to actually examine what constitutes a liberal arts education today.

Students, both men and women, are choosing business because they want to be able to speak the language of business and because of the networks that business education creates, even if they are going into government or the nonprofit sector.

 Unfortunately, the dominant view—and there are exceptions, and there are business schools that are taking leadership here. But the dominance of finance and the kind of “job train” to Wall Street in many of these business schools means that the narrative about business purpose is stuck in the 1970s where Milton Friedman left it off. The result is a curriculum that actually is emphasizing the technical skills of analysis over judgment and long-term vision. The curriculum in way too many schools teaches students essentially to externalize their costs and discount the future—the opposite of what we need now.

Let me just mention a conversation I had, in closing, with my Dad who died at the age of 93 last year. He had worked for the phone company his entire life, but he just loved the market. He spent his retirement years poring over his Value Line subscription on a daily basis. And as I tried to explain to him what the heck I did for a living, and I dropped all the usual buzz words of “corporate social responsibility” and “ethics” and “values” and “stakeholders,” he said, “Aren’t you really just saying that business ought to take a long-term view?”

Chairman BROWN. Smart father.
Ms. SAMUELSON. Exactly.
Chairman BROWN. Thank you, Ms. Samuelson.
Mr. Silvers.

STATEMENT OF DAMON A. SILVERS, POLICY DIRECTOR AND SPECIAL COUNSEL, AFL–CIO

Mr. Silvers. Thank you, Chairman Brown, both for calling this hearing and for all that you have done on these issues, a few of the things which you mentioned in your opening statement.

I am honored to be here together with the AFL–CIO’s partners in the Aspen Institute’s work on short-termism. As Judy noted,
President Trumka is a signatory to the call to counteract short-termism released by the Aspen Institute.

I also am required to note that I serve on the Congressional Oversight Panel for TARP. I am not here on behalf of that Panel.

The United States economy needs investment with long-term time horizons. We need investors to fund our $2.2 trillion infrastructure deficit, to finance our transformation to a low-carbon economy, to finance upgrades to our workforce’s skill set, and perhaps most importantly, to fund research and development work all across our business landscape that is essential if our companies are to remain competitive in a globalized economy.

Instead, by measure after measure, our system of financial markets and financial institutions appears to have rapidly shortening time horizons.

Now, there are multiple sources of short-termism in our capital markets: the rise of cheap credit for risky activity, funded by our trade deficits; the decline of defined benefit pension plans and the growth of a culture of short-termism among pension plan service providers like hedge funds and private equity, as you noted in your opening statement; the deregulation of our financial markets; the weakness of our tax system; and a corporate governance system that in recent years has come to be dominated by an alliance between short-term investors and executives that are incentivized by short-term-oriented pay plans.

And so what has the result of the tilt toward short-termism been for our capital markets? The 10-year rate of return on the U.S. equity markets is negative in nominal terms, and adjusted for inflation it is significantly worse. As for our economy, we have seen a period of jobless growth during the real estate bubble be replaced by a period of disastrous job loss. In the last 10 years, we have lost over 5 million manufacturing jobs. Workers’ incomes were stagnant in real terms before the bubble burst, and now they have declined much further. Poverty rates have risen.

So how can we return our capital markets and financial institutions to a long-term perspective?

The AFL–CIO strongly supports the recommendations in the Aspen Institute letter released in September of last year and the Aspen Institute’s prior document on executive pay principles. We also believe, probably important to note today, that the Wall Street Accountability Act of 2010 contains many significant steps that would encourage a more long-term focus in the capital markets and must be enacted.

A key provision in this respect is the act’s granting of clear jurisdiction to the Securities and Exchange Commission over hedge funds, a provision that must be expanded to cover private equity funds as well.

However, rather than discuss each item in the Aspen letter or the details of the Wall Street Accountability Act, I would like to focus the remainder of my testimony on tax policy. Later today, AFL–CIO President Richard Trumka will be leading a march of more than 10,000 workers to Wall Street under the banner of “Good Jobs Now, Make Wall Street Pay.” I want to explain what we mean by Make Wall Street Pay and why, though it may sound a little odd, that if we make Wall Street pay for the harm the fi-
nancial sector has done to Main Street in the right way, we will encourage Wall Street to return to its proper role of turning savings into investment.

The AFL-CIO has a four-point program for reform in the way we tax the financial system. We support President Obama’s bank tax proposal. We support repealing the capital gains treatment for carried interest, which is the way in which hedge fund and private equity billionaires pay a lower marginal rate than teachers and software programmers. And we support imposing special taxes on short-term-oriented bank bonuses, perhaps in the form suggested by Senator Webb in his bill.

But the fourth item in our program is the most important and is essentially the first item in the Aspen Institute letter, and that is, either changes in capital gains taxes or an excise tax to discourage short-term speculation in the capital markets. This is the proposal Judy mentioned in her testimony. An excise tax to discourage short-term speculation is essentially what we call a financial speculation tax.

A financial speculation tax is the very simple idea of assessing a very small tax on all financial market transactions—stocks, bonds, commodities, derivatives, futures, and options. The Congressional Budget Office estimates that this tax in the form proposed by Senator Harkin and Representative DeFazio would generate over $100 billion a year in revenue. There are studies by European economists suggesting that a smaller tax—not the 25 basis points that Harkin and DeFazio propose, but 5 basis points—would generate a much larger amount of revenue if applied evenly across the world’s major economies, something on the order of 3 percent of global GDP; in the United States, that would be in excess of $300 billion a year.

A financial speculation tax has been endorsed by the governments of the leading economies of the world, including the United Kingdom, France, Germany, Japan, and Brazil. If the United States led in this area, it is clear we would have willing partners.

But as important as the revenue implications of the financial speculation tax are at a time of vast unmet public needs and significant deficits, the true power of such a tax is what the Aspen letter seeks, which is a reorientation of our financial markets toward investing, toward long-term value rather than speculation.

The tax that we are suggesting for people who are simply investing for the long term, as Mr. Rogers seeks to have his investors do, a 5-basis-point tax would be completely inconsequential. It is $5 on every $10,000 invested, which basically covers anything that a typical middle-class American might do in the course of a year. However, its impact on activities like high-speed trading of the type engaged in by Goldman Sachs would be quite significant.

So on behalf of the AFL-CIO, I want to conclude by commending, Senator, the Subcommittee for holding this hearing. The question of capital markets time horizons is critical for our future as a Nation. As a result of the good work of Judy and her colleagues at the Aspen Institute—and I want to particularly note the leadership Judy has shown over the last 10 years in this area; we would not be doing this without her work—Congress now has the benefit of a consensus among business leaders, labor, and institutional inves-
Chairman Brown. Thank you, Mr. Silvers.

Professor Verret, welcome. Thank you for joining us.

STATEMENT OF J.W. VERRET, ASSISTANT PROFESSOR OF LAW, GEORGE MASON UNIVERSITY SCHOOL OF LAW

Mr. Verret. Thank you, Chairman Brown, and thank you for the invitation. I want to express my appreciation for that. It is always a pleasure to be here.

My name is J.W. Verret. I teach corporate and securities law at George Mason Law School. I am also a Senior Scholar with the Mercatus Center and the Director of Financial Regulatory Studies at the International Center for Law and Economics, a network of scholars that works on a variety of regulatory issues.

My research is concerned with corporate governance and examining the incentives that guide corporate decisionmaking. Of particular concern to my research is examining incentives directed at the short-term performance of a company at the expense of its long-term value creation.

I commend this Subcommittee for its focus on the causes of short-termism in today’s capital markets. This is especially important for investors who are in it for the long haul. I will, however, warn that at times special interests might use the phrase long-term investing and have used that phrase as a cover for what are, in fact, purely political goals.

There are two key drivers of short-termism I will discuss today: Politically motivated pressure from institutional investors and quarterly earnings predictions, and I want to express my agreement with some of the concerns that the other witnesses have expressed about quarterly earnings predictions and also with the concerns expressed by Mr. Rogers about a dividend policy, as well.

One cause of short-termism is the Federal securities laws themselves, which encourage Wall Street’s quarterly fixation. And by that, I expressly mean some of the elements of Regulation SK promulgated under the 34 Act. This is an example of some of the unintended consequences of regulation, as the quarterly reporting requirements of the securities laws can actually make the problem worse. Analysts predict quarterly earnings and companies feel pressure to meet those predictions. And I know the Aspen Institute has done a lot of great work in that area.

Another cause of short-term thinking in corporate America is political short-termism. This happens when large investors pressure companies to pursue a special interest above the need to maximize shareholder returns. Institutional investors have frequently used their shareholder leverage to achieve political goals, such as the California Pension Fund’s frequent insistence on environmental or health policy reforms at the companies they target.

In this instance, laws that provide shareholders greater involvement in corporate decisionmaking actually facilitate short-termism. Public pension funds run by State elected officials and union pension funds are among the most vocal proponents of increasing shareholder powers. Provisions in Title IX of the Financial Regulation bill currently being debated on the Senate floor actually stand
to significantly exacerbate this conflict. These special interests seek to achieve through corporate elections what they aren't able to accomplish through political elections.

But the retirement savings of everyday Americans, already under severe strain, should not be used to fund these political objectives. The pensions of working Americans are most certainly in jeopardy. A recent study indicates that State pension funds are underfunded to the tune of over $1 trillion. This could cause pension funds to fail to meet their obligations for retirement funding, cost-of-living increases, and retiree health care benefits for teachers, firefighters, policemen, and other government workers. The most concerning conflict of interest occurs when these special interests cater to voters or to current represented workers at the expense of pensioners and retirees.

Government leaders and business leaders are held accountable by different means. Government leaders are held accountable by their ability to get votes. Business leaders, on the other hand, are held accountable by their ability to obtain profits for shareholders like these pensioners and retirees. And the overwhelming majority of these profits for shareholders go to Main Street investors. Teachers, firefighters, policemen, and other working Americans depend upon this mechanism to fund their retirements.

Special interests will often use the term “long-term investing” as a cover to substitute political discipline for market discipline when business decisions conflict with their ability to advance their special interest. For example, a business shutdown can be a traumatic event in the life of a community and the narrow interest of a particular employee representation group, but at times it is an entirely necessary event.

If a private equity firm were to decide that the capital tied up in a particular business is more productive elsewhere, it has an obligation to its investors, like State pension funds, to sell or close that business and redeploy that capital. That will be an unpopular and difficult decision in the area losing the business, and especially to workers who may lose their jobs. However, those costs can also be more than made up for with increased returns to pension investors and, for instance, in the particular private equity fund, lower costs for consumers, new businesses opened up in other jurisdictions, and the security of the pensioners’ income.

I thank you for the opportunity to testify today and I look forward to answering your questions.

Chairman BROWN. Thank you, Professor Verret, for your insight. Mr. Rogers, I assume that your cathedral thinking metaphor, this was not the first time you employed it. I would love to hear, what happens when you talk in those terms about cathedral thinking with CEOs and other leaders in the investor-owned utilities business and in a broader corporate context. What kind of reaction do you get?

Mr. ROGERS. I think more and more companies are recognizing, particularly at this point when we really need to rebuild our manufacturing base in this country, in a period where we need to rebuild our energy infrastructure, and those are specifically colleagues in the power sector as well as the gas sector, they recognize that it is critical that we have a long-term focus.
And let me say it kind of another way. The notion of why do you run a corporation and who do you run a corporation for, historically, of course, you run it for the investors, both debt and equity, and that is a differentiation in itself. I believe more and more CEOs are thinking that they run their business for all the stakeholders. They run the business for the communities they serve, for their employees, for their customers, for their suppliers, for the environment, for our Government.

And so we have to balance those competing interests, and that balancing of and in itself forces you to have a longer-term focus than just profits tomorrow morning. It also, in my judgment, leads to what I see adopted by more and more CEOs to what I call sustainability in the broader sense of the word, not just limited to sustainability in the context of environmental issues.

So in a sense, as you move from the GE–Welch approach of profit only to more of a stakeholder approach to more of a long-term view and to more of a sustainable organization over time, I think that translates in corporate America increasingly seeing their vision of their company and their role in society evolving.

The unfortunate thing in this is—really the pivotal point today—is the financial community hasn’t really embraced this long-term view, this concept of a sustainable corporation and this concept that you run the business balancing the stakeholder interest. And at the end of the day, over the long term, you will create more and better returns for investors if you run the business consistent with the stakeholder approach.

Chairman BROWN. Thank you. Your comment about China time brings to mind Zhou Enlai. The Chinese leader of three decades or so ago was asked once what he thought of—this was in the 1970s, I think—what he thought about the French Revolution, and he said it is too early to tell.

[Laughter.]

Chairman BROWN. I also get China time in the context that you used it. What is our future? When I see stimulus dollars being spent on buying windmills manufactured in China to install in Texas and other places, and while I expressed my alarm to the Administration on that, I also understand their push-back that our industrial capacity and supply chain has atrophied such in the last decade or two that we are not able to scale up the way we need to.

How does the context of China time and short-termism and financing in an industry like yours get us where we need to so that we don’t have to do that for much longer to buy any of these solar panels from Germany and wind turbines? How do we get these industries scaled up for the kind of production that we need to make in this country?

Mr. ROGERS. Well, first, with respect to wind turbines and solar panels, there is a worldwide glut, and so there is an oversupply today, and when I think about my mission of providing affordable, reliable, clean electricity, one of my missions is affordability, and so if I can buy the component parts at a lower cost and it allows me to achieve my clean objective, even though wind and solar doesn’t allow me to achieve my reliability objective of 24/7, I feel
compelled to—obviously in a period where there is a glut now. That is not going to last.

But here is, in my judgment, directly to your point from my sector’s perspective. We have failed in this country to create energy and environmental policy. Those two policies are inextricably linked. We failed to provide a road map to a low-carbon world. We failed to give clear signals with respect to future regulation of coal plants in this country in terms of sulfur dioxide, nitrogen oxide, et cetera.

And the reason that China is number one in the production of solar panels today and wind turbines and they are building 14 nuclear plants and we are not turning dirt on a single one in this country, they are building a coal plant every other week, they have an economic imperative because of the migration from rural to urban to build out this infrastructure, and by definition, they are going to create supply chains that are going to be lower cost.

But I would say to you, sir, that we have a mandate in this country that has not yet been incorporated in our energy and environmental policy. In our sector, we have to retire and replace every power plant by 2050. If Congress would give us the road map, we would go to work, do the planning, and what that would mean is that would allow us to say, we are going to build a nuclear plant in Southern Ohio, as we have on the drawing boards, or we are going to put smart grid in our customers in Cincinnati as we are now doing. And those commitments that we would make would not only create jobs in the short term, but it would also, more importantly, allow the supply chains, the manufacturing base, to be rebuilt to allow us to build these facilities in the future.

So my belief is, let us get the job done and the road map. We will rebuild the manufacturing base. We will make the commitments. We will raise the capital. But the key to raising the capital, as I said earlier, is getting the tax policy right so that we encourage people to buy and hold, because it takes 10 years-plus, as I said, to build a nuclear plant, 5 years to build a coal plant. It takes a long time to get real earnings stream from these long-term investments.

Chairman BROWN. Transition: We are evolving into what you had said earlier, holding stock long-term and getting tax incentives, if you will, to do that. What do other countries, other rich countries like ours, do with investments when they tax investment income, dividends? Do they have a graduated tax, or graduated in the sense that you pay less if you hold it longer? Is that a new idea or is that something that other countries do to get people to hold investments longer?

Mr. ROGERS. I think that, to my knowledge, that is a new idea. I mean, we are—our corporate rates in the U.S. are probably higher than most of Western Europe today. A dividend tax is a tax on a tax almost. And so what we are encouraging—the only way we get people to invest in our business, because we make long-term investments, is to pay a dividend. And so what we think, it would incent people to buy our stock if they knew they could buy it and hold it and get a lower tax rate over time by holding it over a much longer period. So I think this is a uniquely U.S. policy innovation that really addresses the needs in our country at this time.
Chairman Brown. OK. Thank you. Thank you, Mr. Rogers. Ms. Samuelson, 150,000 M.B.A.s, you said, a year we put out. Do you know the number for engineers?

Ms. Samuelson. A year?

Chairman Brown. Half of that?

Ms. Samuelson. Seventy-thousand and dropping. I am sorry——

Chairman Brown. And dropping.

Ms. Samuelson. Seventy-thousand, maybe, and dropping for engineers.

Chairman Brown. Is the M.B.A. number going up or is it fairly constant?

Ms. Samuelson. Going up.

Chairman Brown. Going up.

Ms. Samuelson. It has been north—it is north of 150,000. But growth in enrollments depends on the school.

Chairman Brown. And that doesn't count marketing majors and business majors in college that don't go on to M.B.A.s.

Ms. Samuelson. Undergraduate is roughly twice that many.

Chairman Brown. And the engineering number for undergraduates——

Ms. Samuelson. Declining.

Chairman Brown. I guess you graduate with an engineering degree as an undergraduate.

Ms. Samuelson. Yes. I think you can get a Master's in engineering, as well——

Chairman Brown. But the 70,000 number you cited for engineers——

Ms. Samuelson. Yes. It would be largely——

Chairman Brown. ——includes undergraduates, mostly undergraduates.

Ms. Samuelson. Correct.

Chairman Brown. Which makes the differential even larger, correct?

Ms. Samuelson. I mean, you have some schools in the country that are literally saying, do we need to cap the number of finance and management and business and commerce degrees because it is starting to take up such a large share of the noise on their campus that they literally are saying it is changing the dynamics of what the school feels like.

Chairman Brown. What about in Europe? Do you know, roughly, those numbers?

Ms. Samuelson. Europe has been kind of graduating to the M.B.A. They didn't—maybe 15 years ago, an M.B.A. was not very common at all. There were some schools that were modeling after the U.S. model. But the M.B.A. was really created in the United States in the 1960s and it is gradually being exported around the globe.

India has 1,200 programs, at last count now, many of these are more informal, but 1,200 M.B.A. programs, believe it or not. China, I think, is approaching about 130 M.B.A. programs. Obviously, 10 years ago, they were called something else, but today, they are called M.B.A. programs. So it has kind of become the degree of choice and is capturing a lot of the top talent.
Chairman Brown. Are business schools doing anything new? I mean, I am sure some are. Tell me about business schools’ move, if it exists in any appreciable amount, to any appreciable degree, addressing the sort of the pitfalls of short-termism. Do you see interesting things that business schools are trying to do?

Ms. Samuelson. Well, the business schools approach this a couple of different ways. The traditional way that they want to do it is put it in the ethics classroom, which, of course, is the wrong place to put it because the ethics classroom is the last thing that matters least in the M.B.A. hierarchy of what is going to help get them a job, unfortunately.

So the traditional way has been to have within the domain of the ethics classroom, all of the discussion about the social and environmental impacts of the business. Ethics has a traditional philosophical basis that does not—that, in fact, is just totally drowned out by the fact that all the rest of the curriculum revolves around the theory of shareholder primacy, which is not something that is written into law, but is still holding forth in business schools and captures most of the noise.

The dominant classroom in M.B.A.s is the finance classroom and the finance faculty are the most important faculty on the campus, and that is just the way that that is—that kind of dynamic is fully engaged and it is hard to work on.

The innovators are doing a couple of things. They are either doing very comprehensive reform of the first year and saying, we need, for example—one example would be the Yale School of Management, which has completely revamped the first year experience and said, what we need to teach is the perspective of all of the different, what one might call, stakeholders of the business. So they actually spend time in modules understanding the perspective of the consumers, the supply chain, of community, et cetera, all of those that touch the business and that the business touches in the course of cycles of business.

So they are doing different things. Other schools are putting design management in, design thinking, and using that, like Rotman University of Toronto. Stanford has put a lot more focus on what they call critical issues management or complex systems analysis.

So some of these things are taking hold. Business schools tend to be fairly invulnerable to change because they are very well funded. They are the cash cows of their university. And they are supported by their graduates, who, of course, are the richest of all of the graduates, and so they tend to be self-supporting in the sense that they kind of have a certain club mentality. But all of those things, there are positive things to say, as well.

Chairman Brown. So the role of stakeholders, i.e., employees, the community, is—cathedral thinking takes a back seat always to the role of shareholders in most of these courses.

Ms. Samuelson. Almost always. The simple metrics are the financial metrics. There is an elegance to them. The models taught, things like net present value, discounting cash-flows, those things tend to focus on very simplistic financial measures which, almost by definition, leave out the more dynamic and complex impacts of the business decision.
So, for example, what you might do in a marketing class, and we have convened marketing faculty, for example, in that discipline for years, is that they would start to say, what is really the elements of long-term reputation and how does a business manage to that, and what are the hallmarks of businesses that do that well, and what are case examples of businesses that have had to balance and have faced reputational freefall and how that could have been avoided.

So there is a lot more. We have a case site called CasePlace.org that has well over 1,000 teaching cases that you can search by all the different disciplines. So you can actually go in and say, what belongs in a marketing class or what belongs in finance.

Clearly, finance today is our focus. We are starting to convene finance faculty who are at least willing to ask the questions about what is it that our students ought to be able to think about when they graduate, given the tremendous attention being paid today to business as an important social institution and the complexity of all the things we have been seeing over the last decade.

So we are identifying very carefully those finance faculty willing to even ask the question and to start to convene them to say, how would we actually change the narrative about the purpose of business, because as long as we are teaching that the purpose of business is to maximize share price today, we are always going to be drowning out all of the important concepts and metrics and dialog that needs to take place about the more complex business that we know is on the ground, is operating. Boards have to manage to complexity all the time. The teaching theory is out of sync with the reality of how business is managed.

Chairman Brown. One last question for you not quite related to that, but you had talked about the stock buy-back. Is that a long-term trend, more stock buy-back, less investment, and if so, what do you see in that happening in the next 10 years?

Ms. Samuelson. I don’t have data on that. I am sorry. All I have is the data from that 2000—the study that was done between 2004 and 2007. I don’t know if——

Chairman Brown. OK.

Ms. Samuelson. I don’t know if that is—and it might have been specific to the market at that time.

Mr. Rogers. I think you have seen more stock buy-backs recently, primarily tied to the fact of a stock price falling so low. So you see more and more companies step up and buy stock back.

I think it is an interesting irony, as I listen to Judy talk about this, and the interesting irony is we have more and more people graduating from business schools and yet the financial literacy of the average American is falling. So at some level, we need a more literate community of citizens in the future, and we clearly need more engineers in the future if we are going to rebuild the manufacturing sector, the energy sector, et cetera.

Chairman Brown. Thank you.

Mr. Silvers and Mr. Verret, let me ask you a question together, Mr. Silvers first. You had talked about the misunderstanding of fiduciary duties in the world of pension fund management. You both talked at some length about the pension issue and what that means for investors.
I want to just briefly recount the Hugo Boss situation in Cleveland. It announced it would keep its last manufacturing plant open just recently in a Cleveland suburb, Brooklyn. The union spent the last 6 months after Hugo Boss announced it was closing its last America plant, production plant, and going to increase its American sales force, moving the production to turkey but trying to increase sales in their best market. The Governor and I had lengthy conversations with the company and others. Last Friday’s announcement, in my view, was a big win where the company challenged the forces of globalization. The employees gave—not particularly well-paid employees, union, but making $12, a little more than $12 an hour, doing a give-back of $1.50 to $2 an hour.

Some interesting policy questions, though, about short-termism and about the fiduciary duty of investment managers arose. Permira is the private equity firm that has a controlling stake in Hugo Boss. After Hugo Boss decided to close the plant—they announced it in December, just 4 months ago—the Ohio Public Employees Retirement System and CalPERS, also, and other pension funds with investments in Permira expressed concern about the decision.

Before the announcement last week, this hearing was scheduled, in part, because we had planned to have Hugo Boss and Permira here, but given the new circumstances, we didn’t see the need to so specifically dwell on their case.

Each of you, give me your thoughts on the role of public pension systems in a situation like this. How does that affect the decisions of Permira and Hugo Boss? Is it appropriate? If you agree it is appropriate, do we engage public pension systems in more perhaps pressure tactics or not, but involvement in these situations? Mr. Silvers, you begin, and then Mr. Verret, I would like to hear your thoughts, too.

Mr. Silvers. Well, Senator, let me first admit that I have a certain bias. I am wearing a suit made in that factory and I am not sure I would have purchased it if it didn’t have the Union label——

Chairman Brown. Except for Ms. Samuelson, you look better than anybody on the panel.

[Laughter.]

Mr. Silvers. Well, that is a rare achievement for me.

Mr. Rogers. I have an American suit on, by the way.

[Laughter.]

Chairman Brown. Without commenting on the fact that—maybe I shouldn’t say this, Mr. Rogers’ collar doesn’t match his shirt——

[Laughter.]

Chairman Brown. Without commenting on that fact, though, go on, Mr. Silvers.

Mr. Silvers. My career began in the—one of my early jobs was for the Clothing and Textile Workers and I learned very early you had to get your collar to match and that kind of thing. They would laugh at you otherwise.

[Laughter.]

Mr. Silvers. Let us start with the Hugo Boss company is owned, as you know, by a private equity firm. The private equity firm doesn’t owe fiduciary duties under ERISA to any of the pension funds that invest in it because of an exemption that was granted
to private equity firms in the 1980s. And it is not entirely clear beyond the sort of common law duties what duties exactly such a fund owes to its pension fund investors. This is why it is important that private equity be included in the Wall Street Accountability Act.

But the managers of pension funds owe fiduciary duties in the management of those assets, including, in general, the communications that they would make to service providers like private equity funds. The misunderstanding, I think, arises when looking at what does that mean, to owe a fiduciary duty—what does acting in the interests of plan beneficiaries mean in a circumstance like the one you are describing?

First, it is very clear, but not often understood, that fiduciary duty is to the long-term best interest of the fund and its beneficiaries and that it is to achieve returns to that fund on a long-term risk adjusted basis. So that means if someone comes along and offers you a proposition in which they say the up side is enormous, the question is, what is the down side? What is the likelihood of bad things happening versus good things happening?

In relation to the matter you described, to the Hugo Boss matter, the real question is should Hugo Boss shut that factory? Should they have shut that factory? Should they have gone in search of cheaper labor, which is, I assume, what they thought they were planning to do. What would be the consequences for Hugo Boss's brand in its largest market?

Now, under ERISA, making this type of decision obviously rests with the private equity fund. But the pension funds—and I should note, by the way, that public pension funds are not covered by ERISA, so it is a little different. But the pension fund has a right to express an opinion.

Now, when it does so, it has to do so looking at the long-term risk adjusted consequences of actions for the fund as an investor. And it also needs, and this is very relevant in terms of some of the issues Mr. Rogers is talking about in terms of energy and the environment, the pension fund has to look at the decisions it makes and the opinions it holds in the context of its full portfolio so that, for example, if I have a particular portfolio company that is making money hand over fist but it is doing so by creating a situation which is going to cause vast losses to everyone else in my portfolio—the behavior of the financial sector in 2006 and 2007 brings this thought to mind—you have to take that into account in looking as a pension fund at how to—at what opinions to have, how to invest your assets, how to hold your money managers accountable.

I think there is a pretty plausible argument. I have not looked over the spreadsheets involved in the Hugo Boss matter, but I think there is a pretty plausible argument that Hugo Boss, which is all about brand—it makes a nice suit, at least I think so, but it is really all about brand—that taking steps in this largest market that would raise questions both as to the impact of that firm on the United States' jobs crisis and potentially impacts, again, on the quality of the product might not be good for Hugo Boss's brand. It seems to me that is an opinion that a pension fund could logically express.
Now, more broadly, and I think this is the key thing in the context of this hearing, the pension funds represent widely diversified patient capital with long-term time horizons. They should be the ideal partners for the type of business culture that Mr. Rogers has described to you today.

The misunderstanding that I believe has occurred in relation to fiduciary duties is a misunderstanding that has led pension funds and their asset managers to increasingly think in terms of single companies, short-term cash-flows—perhaps short-term is quarterly—rather than what they actually are, which is investment funds with very long-term time horizons, fully diversified across the U.S. and the global economy.

Thinking properly as fiduciaries, you end up in the place very much like where the Aspen Institute has ended up and where Mr. Rogers’ testimony has ended up. That does not mean that pension funds shouldn’t be holding businesses accountable for being loyal to their investors, for delivering shareholder value, for acting in the long-term best interests of the funds that invest in them. But it does mean that you have to take that concept of long-term seriously.

Chairman BROWN. Mr. Verret, I assume you do not agree with all that. I would like to hear your thoughts.

Mr. VERRET. Well, I certainly agree with some of it, but I would express some disagreement with some other things as well.

One of the things I would note is that I think, frankly, that at times there is going to be an inherent conflict of interest, just an inherent, unavoidable conflict of interest between the interests of pensioners and the interests of represented workers.

For instance, you know, today we are talking about short-termism in capital markets. State pension funds are underfunded by about $1 trillion, the Pew Center estimates. In many ways it is the next disaster, it is the next crisis, and I think we have got to think forward ahead to it. And I think, you know, there are legitimate short-term interests, right? I mean, a pensioner needs to get that pension check next week. They cannot wait a year. They cannot wait 5 years or 10 years.

So I think an argument about, you know, we are encouraging investors to think more long term, and maybe we will not be able to get you that pension check next week because of the $1 trillion underfunding of pensions is not going to resonate well with that pensioner. They have got a short-term interest that I think is entirely legitimate. And I think we have to think about those conflicts as we empower institutional investors, as we have seen a number of the provisions in the current financial regulation reform bill try to do. And I think, frankly, there is always an inherent tension between sustainability goals, also called the sort of corporate social responsibility movement, and profit maximization.

It is very difficult to link executive compensation and incentives to profit maximization alone. That in itself is difficult. As we add in very amorphous sort of goals, I think accountability becomes even harder, becomes even more difficult.

So I like to stick to the general principle of make business leaders maximize profit and let us have Government leaders deal with
environmental and health policy goals. Keep it clean, keep is sim-
ple, and we will be able to hold people accountable a lot better.

And with respect to—if I could go to the last question for just a
quick second, as a teacher, as a teacher of securities lawyers, I can
say that, you know, my students are very excited about the Wall
Street Reform Act. They think it is going to be a Securities Lawyer
Full Employment Act. So it is a great time for financial rating
agencies; in my own selfish interest, that is great for me. But I do
worry about, you know, instead of engineers, we will have a lot
more securities lawyers, and that might be a little bit of a scary
prospect.

Chairman BROWN. Fair enough. Let me ask you one more ques-
tion, Professor Verret, and then I want to ask each of you the same
question to close, just your thoughts about taxing financial trans-
actions. But I want to ask one question of Mr. Verret first.

Tell me what you thought of Ms. Samuelson's observations about
the number of MBAs and the way we teach MBAs. Does that dis-
turb you? Do you like that? Are you agnostic on that? What were
your thoughts as she was talking about training more MBAs, fewer
engineers, and the way we do train MBAs, mostly in finance, not
much about cathedral thinking or not much about the stakeholders
other than the shareholders?

Mr. VERRET. Well, I think one observation I would offer is that
there is a lot more we can do in terms of how to engage future
business leaders in ideas of concern to stakeholders and to con-
sumers and to the community that fit perfectly within profit maxi-
mization. And I think there is a lot more we can do, and we do not
do enough, and I think we encourage students to think too short
term. I would agree with that completely.

I think in terms of the number of finance specialists we see com-
ing out of MBAs, I think we are going to see that go down as a
result of, you know, fewer employment opportunities. And I think
that is going to lag the crisis, and I think we are going to see a
readjustment there. But I think I would agree that we can cer-
tainly do more to teach future business leaders to think more long
term.

Chairman BROWN. OK. Thank you. Thank you all. I will ask this
last question, and let me just start with Mr. Rogers, if you would
all give me your thoughts on it.

Given the country’s need for revenue, and Mr. Silvers pointed out
what, I think he said, a 25-basis-point tax could do in terms of rev-
ue, should we be considering taxing financial transactions? What
does it mean to long-term growth? What does it mean to damp-
ening speculation? What does it mean to accrual of capital for your
company, Mr. Rogers, or any company as you all comment on it?
We will start with you.

Mr. ROGERS. Yes, sir. Thank you. That is a tough question for
me, and I have not studied the issue in the same way Damon has.
But my judgment is taxing financial transactions is probably not
the right way to go. That would be my visceral reaction.

I think the better approach is really having a tax policy that en-
courages investors to hold stocks for longer periods of time, and I
think that is something that would clear CBO, particularly given
the current, for instance, tax rate on dividends. So I think, quite
frankly, that type of tax policy makes more sense at this time in history.

But my last comment is I wanted just to thank you, Mr. Chairman, for holding this hearing today, but I wanted to be very clear that the reason that I wore this shirt is because I am really a blue-collar worker, but felt like I had to appear as a white-collar worker in front of your Committee.

[Laughter.]

Chairman BROWN. That is why guys like you get on “60 Minutes” when you come up with answers like that.

Ms. Samuelson, your thoughts.

Ms. Samuelson. The working group that pulled together the policy recommendations, the term that they used and that was ultimately signed off on by these 30 business—leaders from business and investment was “market incentives to encourage patient capital.” I mean, my feeling is that, yes, a tax on short-term churning would, in fact, achieve an objective of bringing attention to the costs of short term versus long term, and that we feel would be achieved through that.

The working group, however, was—you know, it was a controversial idea there as well, and a good number of them favored the cap gains tax, skewing the cap gains tax to reward long-term holders. And so I would say that this is light on detail here, so they were putting out that without talking about what some of the consequences might be of either of these approaches. We are doing a follow-up session next week at the Aspen Institute where we are pulling together tax experts from different—from Government as well as some of the nonprofit think tanks, to actually take apart these recommendations, both the cap gains recommendation and some kind of a trading tax and say can we play this out a little bit and how would we best achieve the objective of sustainable patient capital.

So hopefully we will have more on this in a short period of time.

Chairman BROWN. Good. We would like to hear about that.

Mr. Silvers.

Mr. Silvers. Well, clearly from my testimony, you know my general view about this. I would just note that I think that what you hear from all the people involved in the Aspen effort is a common sense that we need our tax policy to incentivize real long-term investment and disincentivize speculation. Some of the business leaders that have signed on want to do this in a way that would either be revenue neutral or would effectively amount to tax breaks for longer-term investors.

The AFL–CIO looks at our long-term public goods needs and the current deficits that we are running as we appropriately address the economic crisis, and we think that we need in the long term to have more revenue. So what you basically end up—and that is a view, also, I think, fundamentally shared by some of the deficit hawks that signed on to the statement. Warren Buffett is an advocate of a financial speculation tax.

I should note that in the last few weeks there have been several sort of major statements in relation to this. The International Monetary Fund in its report to the G-20 clearly states that what they called a financial transactions tax is a feasible method of raising
revenues with some significant policy benefits. There are obviously some challenges in doing it.

At a major economics conference at Cambridge University last month, the former head of the British chief financial regulatory agency concluded his keynote address by saying that the key learning that we should take away in terms of economics from the financial crisis is that liquidity is not in and of itself good in the financial markets, that liquidity driven by excessive leverage deployed through excessive trading volumes, inducing excessive volatility, is a threat to the financial system, and that the economics profession needs to reexamine financial transactions taxes as a way of addressing that threat.

I think that from both the perspective of encouraging long-term investment, discouraging systemic risk, and addressing our Nation’s pressing needs in areas like infrastructure and education, the time has come to look seriously at a financial speculation tax.

Chairman BROWN. Thank you.

Professor Verret.

Mr. VERRET. One of the concerns I would express is one that a number of others have as well, which is one result you would see would be a significant amount of capital flight, and a lot of trading would move to other jurisdictions. And so that would decrease the amount of revenue you could raise from it, and then certainly for the city of New York, a lot of its tax base comes from hedge funds, and I think New York loses a good bit of its tax base. It would lose some of its ability to fund social services, and the whole sort of cycle with—a lot of unintended consequences I think you might see. So I would just express that concern briefly.

Chairman BROWN. Good. Thank you. Thank you all.

The record will stay open for 7 days if you want to add anything, if you want to amend any of your remarks or elaborate on any questions that were asked, if any of the information—I do not know if you said your conference sometimes happens in the next few days, we would love to see that, whether it is in the 7-day period or not, what comes out of that. But I thank you all for your participation and spirited discussion.

The Subcommittee is adjourned. Thanks.

[Whereupon, at 11:21 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]
PREPARED STATEMENT OF JAMES E. ROGERS
CHAIRMAN, CEO, AND PRESIDENT, DUKE ENERGY CORPORATION
APRIL 29, 2010

Mr. Chairman and Members of the Committee: I am delighted to be here today to share with you my thoughts on the need to build better investor recognition of—and incentives for—companies that effectively pursue long-term goals.

Let me start by commending Chairman Brown for holding this hearing. I do not think the private sector is the only place where “short-termism” is alive and well. I am sure that the Members of the Committee also face many instances where they are under pressure to go with short-term fixes for difficult problems that really need long-term solutions. The saying goes that “in politics, the long term is the next election and the short term is the next poll.” So Mr. Chairman, thank you for taking on this difficult yet vital long-term issue that applies to both the private and public sectors.

As you noted in my introduction, I am the Chairman, CEO, and President of Duke Energy Corporation. Duke Energy provides electric power to more than 11 million people in five States: North Carolina, South Carolina, Ohio, Indiana, and Kentucky. Our diversified generation portfolio of 37,000 megawatts mirrors the mixture of supply in the U.S. as a whole with a blend of coal, nuclear, natural gas, and hydro-power. We are also making sizeable investments into large scale renewables such as wind, distributed renewables such as our North Carolina “solar on the rooftop” program, energy efficiency, and the smart grid.

The electric utility industry—my industry—is among the most capital-intensive in the world. We are a big-bet, long-term business. Capital is our lifeblood. For example, Duke Energy has a capital investment program of approximately $25 billion over the next 5 years. Access to capital allows us to modernize our power plants and transmission grid—reducing our impact on the environment, keeping our customers and communities competitive and putting people to work.

Whether the analysts tracking our quarterly performance care or not, decisions we make today at Duke will still be impacting the company decades from now. The power plants we build today will operate for 30, 40, 50 years or more. While too many elements of the investment community may be looking for a quick rise or—quite frankly—a quick decline in our stock price, we are running a business where our decisions impact the company for decades. For Duke Energy to survive, we have to get these decisions right and we have to have investors who understand, appreciate, and share this long view.

Unfortunately, I often feel that the current mindset of Wall Street conflicts with the longer time frames that are the reality of our business. In this hedge fund-driven world of instant earnings gratification, it’s very difficult to justify projects that take years to complete, almost no matter what the payoff is. But think about it, many projects that the U.S. needs for its energy future—the build out of the smart grid, the construction of next generation nuclear power plants, new transmission lines to move renewable power to markets—require years to complete. We are caught between the short attention span of investors and the long-term commitment to a course that these transforming energy projects require.

Myron Steele, Chief Justice of the Delaware Supreme Court has talked about the concept of “patient capital” which bridges this gap between the long lead time that solutions may require and the instant return that too much of the financial world seems to demand:

If we’re going to compete nationally and internationally, we have to focus on what some people have characterized as ‘patient capital.’ We have to develop a framework in which investors can invest for the long term, and allow capital to produce what is typically American—innovative products that impact productivity, generate new ideas, and make our goods marketable across the world. Ultimately, this great engine that is the corporation is designed to enhance wealth for those who invest in it.

Last fall, I had the privilege of joining 28 leaders representing business, investment, government, academia, and labor of the Aspen Institute Business & Society Program’s Corporate Values Strategy Group to endorse a call to end the focus on short-termism. In our statement, “Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management” (attached to my testimony), we provided recommendations to focus attention and dialogue on the intricate problems of short-termism and what we believe are the key leverage points to return to a responsible and balanced approach to business and investment.
Our work recognizes the need to focus on the whole system. We made recommendations in three areas:

- **Market Incentives**: Encouraging more patient capital;
- **Fiduciary Duty**: Better aligning interests of financial intermediaries and their investors; and
- **Transparency**: Strengthening investor disclosures.

I believe Judy Samuelson, the Executive Director of the Aspen Institute Business & Society Program, is going to address this report and the comprehensive set of changes that we recommend. I would like to focus on the first set of recommendations regarding investor incentives for patient capital.

In the report, we identified several structural changes to enhance incentives to patient investors, including:

- Increasing capital gains discounts for greater holding periods of stock;
- Removing deduction limitations on long-term capital losses; and
- Enhancing shareholder rights for shareholders who meet certain minimum holding period requirements.

I strongly believe that these changes are needed and will increase investor stability and patience. But, beyond these three recommendations, we need to ensure that all of our policies to promote long-term investments work in harmony. That leads me to highlight another current source of stability—favorable tax treatment of dividends for individual shareholders—that is in danger of being lost.

Currently, dividend income for individuals is subject to only a 15 percent tax rate, instead of the larger marginal tax rate that would otherwise apply. However, this treatment expires at the end of this year. Encouraging dividend payout through tax policy promotes investor stability and long-term holding in two ways. If that tax treatment expires, it will work at cross purposes with the goal of promoting long-term investor focus. Here’s why:

First, with dividends, investors do not have to sell shares to harvest the underlying company’s profits; they share in that profitability directly through the dividend payout. Compare, say, Apple Computer—which may make billions in a year due to the introduction of its latest hot new gizmo. But, Apple has never paid out a dividend. There is only one way for an investor to gain access to these profits—they have to sell the shares and secure the capital gain that the market has hopefully priced into Apple’s shares. And by the way, when they sell after a modest hold, they secure a discounted tax treatment due to the long-term capital gains tax provisions.

Second, and more importantly, dividend stocks create steady income vehicles for investors. And in a world of disappearing pensions and longer life expectancies, dividends can provide a vital source of income for retirees. An investor that is motivated by the dividend will generally be a loyal, long-term investor—so long as the Company performs.

This has certainly been our experience at Duke Energy. Our outstanding shares of common stock are currently held equally by institutional investors and retail investors. And, just over 10 percent of our institutional shares are held by investors with an investment style oriented toward income (i.e., dividend payments). Our high retail ownership is supported by the relatively low volatility of our stock price and our consistent dividend distribution. 2010 is the 84th consecutive year that Duke Energy has paid a quarterly cash dividend on its common stock.

This is not just true for Duke Energy. Nationally, we see the utility dividend providing needed income to retirees and the middle class. For instance, Ernst & Young studied tax returns in 2007 and noted the following characteristics of taxpayers claiming the dividend deduction:

- 61 percent are from taxpayers age 50 and older,
- 30 percent are from taxpayers age 65 and older,
- 65 percent are from returns with incomes less than $100,000, and
- 36 percent are from returns with incomes less than $50,000. (See, Ernst & Young report attached.)

It will be a giant step backwards if we eliminate the incentives we now have for all investors regardless of their income level to hold stocks for the dividend payment. In this instance the public policy goal of encouraging individuals to hold dividend-paying stocks (especially utilities who are modernizing their aging infrastructure) for the long-term trumps the need to increase the tax rate on dividends and to have a progressive tax regime for dividends.
In my judgment and experience, short-termism constrains the ability of a business to do the things that it must do to prosper: create sustainable goods and services, invest in innovation, take risks and develop human capital. We cannot create an economic recovery without financial policies that incent this behavior.

Thank you for your attention and I look forward to your questions.

PREPARED STATEMENT OF JUDITH F. SAMUELSON
EXECUTIVE DIRECTOR, BUSINESS AND SOCIETY PROGRAM, ASPEN INSTITUTE
APRIL 29, 2010

Mr. Chairman and Members of the Committee, I am Judith Samuelson, Executive Director of the Business and Society Program of the Aspen Institute. The mission of the Business and Society Program is to align business with the long-term health of society.

Thank you for the opportunity to present ideas about curbing short-termism in business and capital markets. These ideas come out of dialogue that we began in 2003, building on the findings of a Blue Ribbon Commission convened by The Conference Board in 2002 that probed the rapid demise of Enron.

My father passed away last year at the age of 93. He spent his career at Pacific Telephone but he always loved the market and spent many hours a day in his retirement years pouring over the stock pages and his subscription to Value Line. I tried once to explain what I did for a living; I tried various terms and buzz words to explain the work we do that is aimed at influencing business—corporate social responsibility, environmental consciousness, stakeholders, leadership, ethics, values—but nothing was sticking. After a long and awkward pause, he finally said, bluntly, “Aren’t you just trying to say that business ought to take a long-term view?”

He was right, of course. It took me a few more years to change the mission statement of our organization, but I have come to believe it is all about time frame. It’s also about balance, judgment, and restoring trust in business. It’s about recognizing the reality that the system is perfectly designed for the results we have now. If we want a different result, we need to change the rules that govern business decision-making.

Initially, the focus of the Aspen dialogue was on whether market short-termism exists, and if so, why it is a problem. It then moved to examine the sources of the behaviors and the solution space. Finally, a series of working groups were formed to build consensus across trade groups and individuals—including entities that rarely work together and don’t often agree—to develop the ideas for extending time horizons that have the greatest potential leverage. The Aspen Corporate Values Strategy Group continues to tackle the problem through dialogue, research, and education. Both Duke Energy and the AFL-CIO are among the signatories of two rounds of recommendations, released in 2007 and 2009, and I am pleased to present with them today.

I personally believe the issue you are beginning to explore is critical for our country and, for the globe. In fact, I cannot think of anything more important. I am not trying to be dramatic here; but having spent about 10 years building this dialogue with hundreds of individuals and leaders across business, investment, academia, labor, and other trade associations and partners, I remain convinced that extending time horizons in business and capital markets is worthy of our time and resources, and of yours. And, importantly, there is opportunity now to make a difference.

What do we mean by market short-termism? The UN Brundtland Commission in 1987 coined what has become the most common definition of sustainable development: meeting the needs of the present without compromising the ability of future generations to meet their own needs. Short-termism is the antithesis of sustainable development: it’s about making decisions to meet some benchmark today without regard for the needs of, or the costs imposed on, the future. Most often, the metrics employed are the narrowest of financial measures, like short-term changes in return on equity and share price, which fail to capture the more complex impacts of business and investment as they play out over a longer term. For the purpose of the Aspen dialogue, we eventually settled on a 5-year time frame to constitute “long term,” but clearly, it depends on the nature of the decision or context.

Is there a problem with market short-termism?
Here is some of the evidence that short-termism is growing—and creating real problems:

1 See, “Compelling Case for Change”, a publication of the Aspen Institute Corporate Values Strategy Group, for a summary of relevant research.
• The number of firms offering the market short-term or quarterly forecasts grew from a handful—92 in 1994, according to one McKinsey study, to over 1,200 by the time of the Enron implosion in 2001. The fact that Enron and other firms with fraudulent financials began their fall from grace by managing earnings in order to “beat” these same quarterly earnings forecast is evidence of the pernicious effect of this practice.

• A significant stream of academic literature suggest deferred or cancelled R&D and Net Present Value (NPV) positive projects within firms as a consequence of an excessive focus on Earnings Per Share (EPS) as the most important metric for judging firm performance and/or response to a large block of short-term holders in a firm’s shareholder base. One stunning statistic from a survey of 400 CFOs suggests that 80 percent will cut discretionary spending—for R&D, maintenance, advertising, etc.—to avoid missing a quarterly forecast.

• Professor Lawrence Mitchell at GWU School of Law has found that from 2004 to 2007, 270 (or 54 percent) of S&P 500 companies spent more money on stock buy-backs than on productive investments.

• A January 2010 working paper by Filippo Belloc, researcher at the University of Siena, found that “countries with stronger shareholder protection tend to have larger market capitalization but also lower innovation activity.”

• Finally, participants in our dialogue talk about a growing aversion to being a public company at all, at least in part because of short-term pressures, although not exclusively for that reason.

• And, we are not the only organization concerned with market short-termism. We began collaborating with the CFA Institute, Committee for Economic Development (CED), U.S. Chamber of Commerce, and the BRT-funded Institute for Corporate Ethics in December 2007, as all five organizations had published reports on the issue in the prior 2 years.

Although the fallout from Enron offered the hook to begin this conversation about curbing short-termism, and the financial crisis that continues to play out globally is certainly a convincing reason to stay at this work, it is not just about avoiding another financial catastrophe. Instead we began this work out of respect for the both ordinary, and extraordinary, capacities of business and how critical that capacity is to our success as a nation and in globally connected markets. Behind that scale of operation lie remarkable reach and distribution systems, research and management talent, and problem-solving skills—not to speak of financial wealth and other resources. It is hard to imagine solving our most important problems as a country or a world without business at the table in a big way. But whether we are talking about climate change or poverty, it’s equally hard to imagine harnessing this same capacity of business for the public good, as long as managers move from 90 day calendar—to 90 day calendar.

In spite of examples to the contrary of which we are all aware, most businesses naturally think long term. Long-term focus is inherent in the process of building and guarding the unique contributions and reputation of any enterprise. Companies with any degree of resilience are mindful of the myriad relationships that feed its success, from retention of top talent to the quality of relationships with customers and suppliers and the host communities that offer up the license to operate. But it is also true, that the world we now inhabit has changed as a result of investment, finance, and financial services representing a larger and larger share of GNP—growing steadily from less than 16 percent of corporate profits in the 70s and 80s, to over 40 percent this decade. And the pressures to think and act short term in this sector are abundant, and are deeply influenced by fees and compensation systems driven by financial metrics and share price, as the financial crisis has ably demonstrated.

The statistics are pretty clear on this point. Even if you correct for technology enabled “flash trading” and day-trading, the average holding period of stock continues to fall. In 1960, the holding period for equities averaged about 9 years; by 1990, it had fallen to just over 2 years, and today, it is less than a year. And corporate man-

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2See the work of Graham, Harvey, and Rajgopal; Subramanyan, Chen and Zhang; and Bushue.

3“From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits. In 1986, that figure reached 19 percent. In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period. This decade, it reached 41 percent. Pay rose just as dramatically." Cited by Simon Johnson of MIT, “The Quiet Coup”, The Atlantic, May 2009.
agers often focus on short-term performance because that’s what many of their most powerful investors want them to do.

Indra Nooyi, CEO of PepsiCo, in a recent speech to the Economic Club of Chicago talks about the influence of “real-time global news and financial updates” and “24/7 media that amplifies the smallest missteps forcing corporate leaders to be constantly on guard—with precious little time to pause and think.” The attention span of investors is playing out in the tenure of CEOs—which continues to fall: 40 percent of CEOs now last 2 years or less on the job. (No wonder they command outsized contracts that promise rewards on an early departure.) I quote Ms. Nooyi: “Attention spans are short, time is money, and there is a premium on speed.”

In her speech she goes on to propose a number of important changes, including, the need to identify internal management metrics to reward what she calls “sustainable performance”—that speaks to a broader definition of business success and intangible value that financial markets seem to ignore, or at least, undervalue in their obsession with quarterly results.

In this vein, a set of Guiding Principles for business practice were released by the Aspen Corporate Values Strategy Group in June 2007. They speak to voluntary measures that operating companies and investors can take to focus greater attention on long-term value creation and to create a defense against short-term financial pressures. The so-called “Aspen Principles” were drafted and endorsed by business, investors, labor, and corporate governance gurus. These include the Business Roundtable, the Council of Institutional Investors, the AFL-CIO and Change to Win labor federations, the Center for Audit Quality representing the accounting industry, and pension funds CalPERS, CalSTRS, and TIAA–CREF. The Principles focus on companies having the right metrics for judging success, driving a higher quality of communication with investors and long-term orientation in compensation of investment and business managers. It is not rocket science, but the agreement across this set of signatories was remarkable in itself. Six public companies added their names to the document as a signal to their peers and to their internal constituencies of the importance of moving in this direction, including Duke Energy, PepsiCo, and also Pfizer, Xerox, Apache Corporation and Office Depot. There is much more to be done that is well within the control of managers and boards.

However, 2 years later in September 2009, a working group took the additional step of recommending public policy changes to support the actions of companies working to stay long, and to focus attention on “shareholder short-termism.” Much attention has been paid of late to the rights of shareholders, but many in the working group believed it also important to recognize that with rights should come responsibilities.

Both of these documents are available publicly and are incorporated here as part of my testimony. The principal recommendation of that working group, which has now been endorsed by 30 leaders from business and investment in a widely circulated Call to Action, is to create market incentives that reward long-term investment. For example, this might be accomplished by imposing an excise tax on trading, or by skewing the capital gains tax to greatly favor long-term holdings. Individual signers have proposed moving the cap gains to 0 percent after 10 years, with a high tax at the short end of the investor continuum. These taxes could be revenue generators or revenue neutral; neither tax is a new idea and both are controversial for different reasons. The drafters of the “Overcoming Short-Termism” statement did not offer specifics, except to say that nontaxable entities also needed consideration, which might come in the form of modifications to ERISA.

4 “Short vs. Long-Term: Getting the Balance Right”, Indra Nooyi, April 12, 2010.
5 “Long-Term Value Creation: Guiding Principles for Corporations and Investors”; released by The Aspen Institute Corporate Values Strategy Group, June 2007
6 For example, in January 2010 TIAA-CREF released “Responsible Investing and Corporate Governance” that highlighted lessons learned over the past decade and among other things, encouraged investors to take a long-term orientation. Also see Benjamin Heineman, Jr., “Shareholders: Part of the Solution or Part of the Problem?” The Atlantic, October 28, 2009.
7 “Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management” released by the Aspen Institute Corporate Values Strategy Group, September 2009
8 ERISA managers need reassurance they are free to act in the long-term interests of their investors; that no legal mandate to maximize short-term returns exists. Further, given that ERISA investment gains are not taxed, it is necessary to apply a similar tax on gains, or on trading at the fund level of pension assets, in order to align incentives with long term. For example, managers that hold for less than 24 months could be subject to a modest transaction tax or penalty on the gains.
Other recommendations in the Call to Action address the need for better definition of fiduciary duty, as it applies to financial intermediaries and also to strengthen investor disclosures to illuminate the borrowing and lending of shares in order to make the actual position—short or long—of large holders transparent.

The range of signatories behind these ideas and recommendations, again, defies the usual alliances—Warren Buffet signed, but so did Richard Trumka of the AFL–CIO. Long time investors Felix Rohatyn, Peter Peterson, John Bogle, Lester Crown, Jim Crown, and James Wolfensohn signed, as well as Steve Denning, current head of General Atlantic Partners, a $15 billion private equity firm. The former CEOs of IBM, Cummins Engine, Medtronic signed, but so did the current CEOs of Alcoa, Duke Energy, and TIAA–CREF.

And this is not the only thing that needs attention.

Last year some 150,000 students graduated from this country’s MBA programs—roughly the same number as those seeking teaching credentials—and far out-pacing professional degrees in law, medicine, and engineering. Twice that many are choosing undergraduate majors in business, economics, and commerce each year—challenging colleges and universities to examine what constitutes a liberal arts education. Students, both men and women, are choosing business because that is where the best paid jobs are, but also because they have grown up in an era that values the skill set offered. Even if a student is planning a career in nonprofits or government, they want to learn the language of business and enjoy the networks that business education offers to them.

Unfortunately, given the dominance of finance and the “job train” to Wall Street in many business schools, the narrative about business purpose is stuck in the 1970s when Milton Friedman penned his famous article. The result is a curriculum that emphasizes the technical skills of analysis over judgment and long-term vision. The curriculum in too many schools teaches students to externalize costs and discount the future. Innovators and visionaries in business schools are starting to be heard and changes are beginning to take place, but much more work is needed.

Thank you again for the opportunity to address the Subcommittee on Economic Policy.

PREPARED STATEMENT OF DAMON A. SILVERS
POLICY DIRECTOR AND SPECIAL COUNSEL, AFL–CIO
APRIL 29, 2010

Good morning Chairman Brown, Ranking Member DeMint, and Members of the Subcommittee. I am very pleased to appear before you today on behalf of the American Federation of Labor and Congress of Industrial Organizations to discuss the challenge of lengthening the time horizons of U.S. capital markets. The AFL–CIO has worked for a number of years with the Aspen Institute to foster a dialogue on this issue between business leaders, institutional investors, the labor movement and the academic community. That dialogue has led to both the Aspen Institute Principles on Executive Compensation and last fall’s statement “Overcoming Short Termism: A Call for a More Responsible Approach to Investment and Business Management,” signed by AFL–CIO President Richard Trumka and a number of leaders in the business and institutional investor community, including Warren Buffett and Pete Peterson.

Capital markets and financial institutions’ purpose is to transform savings into investment. Investment means new capital equipment and new software, developing employee skills, financing research and development teams. I can save money by putting it my mattress, and it has not been invested. I can also save money and use it to fund my visits to Las Vegas, and that is also not investment, even if I win at blackjack.

The U.S. economy needs investment with long-term time horizons. We need investors to fund our $2.2 trillion infrastructure deficit, to finance our transformation to a low carbon economy, to finance upgrades to our workforce’s skill set, and perhaps most importantly, to fund research and development work all across our business landscape that is essential if our companies are to remain competitive in a globalized economy. All these tasks require patient capital—capital willing to commit for the long haul.

Instead, by measure after measure, our system of financial markets and financial institutions appears to have rapidly shortening time horizons. The average mutual fund holding period for investments in equities has shrunk to less than a year. A recent study of 991 equity fund managers by Mercer found that from 2006 to 2009, two-thirds exceeded their target turnover rates, with the average annual turnover
rate at 72 percent. While data is not available, most market participants believe holding periods for the several trillion dollars invested in hedge funds is significantly shorter. Leveraged buyout funds, now renamed private equity funds, assert they are long-term holders because sometimes they make 5-year investments. And in the aftermath of the financial crisis, the large financial institutions that dominate our markets have turned to proprietary trading to make up for their losses in the credit markets. In the extreme, proprietary trading takes the form of high frequency trading, the use of computer algorithms to generate thousands of trades a day—a technique apparently pioneered by Goldman Sachs, which according to press reports has paid stock exchanges for the privilege of placing Goldman’s computers literally in the same room as the exchanges’ to get a little bit of a timing advantage—a practice called colocation.

There are multiple sources of short-termism in our capital markets. The rise of cheap credit for risky activity, funded by our trade deficits, has made a variety of short-term strategies far more tempting than would have been true in the past. The decline of defined benefit pension plans has meant that both those pension plans that remain and individual workers trying to provide for retirement on their own have been forced to look for higher rates of return than are available through buy and hold strategies. The fact that these higher rates of return are illusory has not stopped both individuals and institutions from pursuing them.

Deregulation of our financial markets has been a potent contributor to the rise of short-termism. We have deregulated the use of leverage in our equity markets—both directly and indirectly through the regulatory loopholes hedge funds operate in. We have allowed the development of a shadow credit and insurance system in the form of derivatives, without meaningful transparency and capital requirements, and we have allowed our major financial institutions to become short-term actors in the securities markets, rather than providers of long-term credit to productive enterprise.

Our tax system also contributes to the short-term orientation of our capital markets. While capital gains taxes do have a time differential associated with them, it is a simple 1-year cliff, structure. The result is that billionaire private equity fund managers use the carried interest tax loophole to pay income tax rates lower than that paid by middle class Americans for the profits on investment strategies whose time horizon is shorter than a turn of the economic cycle. In addition, vast pools of capital devoted to retirement savings are properly tax exempt, so the tax system provides no incentive for long-term investment of those funds. Finally, and perhaps most importantly, the tax treatment of executive pay makes no distinction in giving tax preference to performance based pay between short-term and long-term performance-based pay.

Finally, there has been a culture of misunderstanding of fiduciary duties in the world of pension fund management. Fiduciaries clearly have duties to maximize the long-term risk adjusted rate of return on their funds. But throughout the chain of investment management decision making, fund service providers have financial incentives to seek short-term gains, often at the expense of the long-term health of the plan, or to look at investment decisions in isolation from the plan’s overall portfolio and investment objectives. Actions by the Bush Administration in its waning days exacerbated these tendencies by issuing guidance letters that appeared to discourage fiduciaries from policing service providers or companies plan assets were invested in, or considering either plan’s overall portfolios or their actual investment objectives.

All these factors contribute to a corporate governance system that has tilted severely in the direction of short-term time horizons. The most radical version of this is the story of Countrywide Financial and its CEO Angelo Mozillo, over who took $400 million in total compensation out of that company during the real estate bubble, only to have the company go bankrupt. But though Countrywide is an extreme case, there was nothing unusual about the basic nature of its pay packages. Typical corporate pay packages provide for the vesting of stock based pay in 3 years, a time period short enough to be exploited, and a structure that allows, and in fact encourages executives to manage their firm with an eye toward a specific date, rather for the long-term health of the firm. A 2005 study of 400 public company financial executives found the majority would not initiate a positive net present value project if it negatively affected the next quarter’s earnings.

And so what has the result of the tilt toward short-termism been for our capital markets? The 10-year rate of return on the U.S. equity markets is negative in nominal terms—adjusted for inflation it is significantly worse. And for our economy—we have seen a period of jobless growth during the real estate bubble be replaced by a period of disastrous job loss. In the last 10 years we have lost over 5 million manufacturing jobs. Workers’ incomes were stagnant in real terms before the bubble
burst, and now they have declined much further. Poverty rates have risen. And our capital markets have simply failed to invest in the key long-term needs of our society—as evidenced by our $2 trillion infrastructure deficit.

So how can we return our capital markets and financial institutions to a long-term perspective, the kind of perspective necessary for those markets and institutions to return to their proper purpose of channeling savings into investment, rather than speculation?

The AFL–CIO strongly supports the recommendations in the Aspen Institute letter. We also believe that the Wall Street Accountability Act of 2010 contains many significant steps that would encourage a more long-term focus in the capital markets, and must be enacted.

However, rather than discuss each item in the Aspen letter, or the details of the Wall Street Accountability Act, I would like to focus the remainder of my testimony on tax policy—because the AFL–CIO believes capital markets tax policy is central to the future of our Nation. Later today, AFL–CIO President Richard Trumka will be leading a march of more than 10,000 workers to Wall Street under the banner “Good Jobs Now, Make Wall Street Pay.” I want to explain what we mean by “Make Wall Street Pay,” and why though it may sound a little odd, that if we make Wall Street pay for the harm the financial sector has done to Main Street in the right way, we will encourage Wall Street to return to its proper function as an intermediary between savings and investment, which will be good for our financial system and good for our country.

The AFL–CIO has a four point program for reform in the way we tax the financial system. We support President Obama’s bank tax. The first item in the Aspen Institute letter is an item encouraging Congress to consider either changes in capital gains taxes or an excise tax to discourage short-term speculation in the capital markets. An excise tax to discourage short-term speculation is essentially a Financial Speculation Tax.

A Financial Speculation Tax is the very simple idea of assessing a very small tax on all financial market transactions—stocks, bonds, commodities, derivatives, futures, and options. Senator Harkin and Congressman DeFazio have sponsored bills proposing a 25 basis point tax with an exemption for retirement plans. A broad coalition in Europe has suggested a 5 basis point tax. The Congressional Budget Office estimates the Harkin-DeFazio proposal would generate over $100 billion a year in revenue. Leading European economists have estimated a 5 basis point tax implemented across the major economies could generate 3 percent of global GDP in revenue. A Financial Speculation Tax has been endorsed by the governments of the leading economies of the world, including the United Kingdom, France, Germany, Japan, and Brazil. If the United States led in this area, it is clear we have willing partners.

But as important as the revenue implications of the Financial Speculation Tax are at a time of vast unmet public needs, the true power of such a tax is what the Aspen letter seeks—which is a reorientation of our capital markets toward investing, toward long-term value rather than speculation.

On behalf of the AFL–CIO, I want to commend the Subcommittee for holding this hearing. The question of capital markets time horizons is critical for our future as a Nation. As a result of the good work of the Aspen Institute, Congress has the benefit of a consensus among business leaders, labor, and institutional investors. The AFL–CIO stands ready to assist you in acting in this area. Thank you.
RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER
FROM DAMON A. SILVERS

Q.1. In your testimony you say, “The 10-year rate of return on the U.S. equity markets is negative in nominal terms—adjusted for inflation it is significantly worse.” Could you give the dates and index from which you found this information? Is this reflective of normal market conditions and return or was this number significantly impacted by the recession in 2008 and 2009?

A.1. Answer not received by time of publication.

Q.2. With the financial sector being one of the major growth industries in the U.S. economy, are you concerned that implementing a tax on all financial market transactions would severely stifle growth and innovation in the financial sector? How do you think this will impact capital formation and jobs?

A.1. Answer not received by time of publication.
STATEMENT OF JAMES P. HOFFA, GENERAL PRESIDENT,
INTERNATIONAL BROTHERHOOD OF TEAMSTERS

I am pleased to present the views of The International Brotherhood of Teamsters on short-termism in the financial markets. The Teamsters represent 1.4 million workers across North America. Teamster-affiliated pension and benefit plans together have more than $100 billion invested in the capital markets. As both workers and investors, we have witnessed the destruction wrought by the short-term, speculative orientation of our capital markets.

Our members have directly experienced the near-destruction of profitable companies by short-term, profit-focused investors, specifically, private equity firms. We have encountered the tragic human cost of the short-term needs of private equity managers. Those costs include dangerous working conditions; lower wages, benefits and contract standards; massive layoffs; attacks on workers' fundamental rights; unsustainable speed-ups; and streams of plant closures.

We have also paid a financial price for the short-term needs of private equity managers. Our pension and benefit plans, which represent the retirement security and health and welfare of Teamster members and retirees, are long-term investors that require sustainable returns. They suffered unprecedented losses from the economic crisis of 2000–2002, when accounting scandals and corporate greed erased billions in shareholder value.

These funds rely on dependable and sustainable returns over time that allow the funds to deliver benefits to plan participants as promised in collective bargaining agreements. After the dot-com bust in 2000, institutional investors like us were again victimized when investment firms and vehicles' primary focus shifted to high-risk, short-term trading gains by exploiting the un- or under-regulated capital markets. The capital market deregulation of the past three decades has served investment firms well. It has, however, created unwelcome risk to long-term minded institutional investors such as Teamster-affiliated benefit funds.

Deregulation made high-risk investment schemes the norm in the capital markets. It shifted corporations' goals and company executives' focus from long-term growth in shareholder value to meeting and exceeding quarterly targets. This shift in corporate dynamics led to the rapid growth of executive pay in the United States. Chief executives receive incentives by their boards of directors to meet quarterly or yearly benchmarks—whether or not that affects the long-term health of the company. Further, the lure of riches for spending a short time on the job can lead to greater executive turnover without proper planning for executive succession.

The costs of the shift to short-termism have been devastating to the U.S. economy. Managers seeking lean budgets for quarterly reports frequently start cutting costs by eliminating jobs. This process starts a downward spiral. With the loss of jobs, communities are hurt because working families can no longer spend in the local economy. Tax revenue dries up and public services are at risk. Local businesses, hurt by the drop in consumer spending, are forced to further tighten their belts. A company can no longer invest in its business and create jobs.

The private equity model of management is a prime example of how short-termism can destroy a company's sustainability and, in turn, damage workers, communities, benefit funds, and the U.S. economy.

Private equity firms dominated merger and acquisition activity during the 1980s, taking advantage of cheap and readily available credit. When the financial crisis hit and the credit markets dried up, companies were overburdened with debt and high fees to pay the private equity managers. These highly leveraged companies were also often saddled with management teams charged with meeting the short-term needs of the private equity managers over the company's long-term health. Following are two case studies that demonstrate how private equity has harmed workers, communities, and investors.

Accuride, a Case Study

Accuride is a manufacturer of steel and aluminum wheels. It was one of the most diversified suppliers of commercial vehicle components in North America, with little foreign competition. A private equity firm drained it of cash and then sold it at a profit. Left behind was a damaged enterprise that had to seek bankruptcy protection, its shares trading for pennies and its workforce cut in half.

Accuride was purchased in 1998 by one of the country's largest and most powerful private equity firms, Kohlberg, Kravis, and Roberts (KKR). KKR paid $468 million, putting down $108 million in equity and borrowing the rest. In 2005, KKR merged Accuride with ITT, which was owned by another private equity firm Triman Cap-
ital, LLC. In 2005, KKR launched an initial public offering (IPO) of the combined company on the New York Stock Exchange. The IPO’s target price was between $17 and $19 dollars, but Accuride’s share price closed at around $9 the day of the offering.

From then on, KKR simply waited for market conditions to improve. In the meantime, it cut costs by gutting workers’ wages and benefits and avoiding reinvestment into the business.

In the late spring of 2007, KKR sold its shares for about $14. KKR made a positive return on its investment but Accuride’s workers and investors didn’t make out so well.

In 2006, Accuride employed over 4,400 employees. It has lost almost half of its workforce, according to the latest figures. Accuride’s share price took a nosedive and the company was delisted from the New York Stock Exchange. It filed for Chapter 11 bankruptcy reorganization in October and its share price was trading for 17 cents a share on February 19.

![Accuride Corporation](chart.png)

Source: Corporate Information.com; accessed on 4-12-10.

Having gone through an entire cycle of private equity investment, Accuride shows the risks that KKR posed to investors and employees.

1. **Excessive debt.** Interest expense in 2005 was $71 million, 36 percent of EBITDA (earnings before interest, depreciation and taxes, a measurement of cash earnings).

2. **High “management and advisory fees.”** KKR took $16.5 million in fees from Accuride by 2007 and Trimaran took out $5.7 million. (These are separate from the fees charged to investors in private equity funds, which usually are a fixed percentage of the fund.)

3. **Chronic underinvestment.** Only after a machine breakdown severely undermined production did the company invest in new equipment at its wheels factory in Erie, Pennsylvania, and claimed to have stepped up maintenance;

4. **Disregard for unsafe working conditions.** A floor collapsed in the GUNITE Foundry in Rockford on June 27, 2007. A worker took refuge on top of a dust collecting machine as the floor collapsed below him. OSHA had cited the foundry for...

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1 SEC Form10-K for Accuride (ACW), and 2005 Prospectus to Investors (Form S-1).
2 Prospectus for 2005 IPO by Accuride, and following SEC filings.
3 “Accuride Corporation Announces Aluminum Wheel Forging Presses Operating at Full Production Following Outages”, 6-3-06. Accuride Press Release.
4 “No Disruption at Gunite despite floor collapse”. 1/30/07. Alex Gary. Rockford Register Star.
violations of air quality standards in 1998\(^5\) due to the persistent problem of silica dust.

5. **Undermining workers’ jobs, wages, benefits, and standards.** The company slashed its workforce and launched an aggressive drive to cut wages, benefits, and contract standards.

### U.S. Foodservice, a Case Study

U.S. Foodservice is the second largest broad-line food distributor in the United States with $19 billion dollars in sales. Of the 26,000 workers at U.S. Foodservice, about 3,900 of U.S. Foodservice employees are Teamsters. It is these workers who are bearing the brunt of the enormous debt amassed by two private equity firms who took over the company.

In 2007 KKR and CD&R, two of the largest private equity companies in the U.S., acquired control of U.S. Foodservice for $7.3 billion, with $2.3 billion of their own cash and $5 billion in debt. They borrowed nearly 70 percent of the purchase price, and pushed the newly acquired company to a very high debt load, with an estimated debt-to-EBITDA ratio greater than 9.3.\(^6\)

In 2007, analysts thought the $7.1 billion dollar valuation was excessive, having evaluated the company at $5.1 to $5.7 billion in 2006.\(^7\) By 2009, the value of U.S. Foodservice had been severely marked down.\(^8\)

KKR and CD&R struggled to place the debt with investors who were growing wary of a highly leveraged deal\(^9\) at the end of the cheap financing bubble on Wall Street and the beginning of a sustained global recession. Not surprisingly, KKR and CD&R had to complete the deal under more onerous loan terms, putting additional pressure on the two firms to meet their revenue goals with U.S. Foodservice.

With such a mountain of debt and lower valuation for an eventual resale of U.S. Foodservice to the public, the pressure on U.S. Foodservice workers has been unremitting:

1. **Abuse of workers.** Repeated attacks on workers fundamental rights, including violations of U.S. labor law, illegal firings, intimidation, captive audience meetings, racial discrimination, discrimination on the basis of union sympathy; with the aim of undermining collective bargaining, wages, and benefits.\(^10\) In Arizona, the National Labor Relations Board (NLRB) charged U.S. Foodservice with almost 200 Federal labor law violations before, during, and after a 2008 union election involving 250 workers in Phoenix. That same year, the NLRB charged U.S. Foodservice with violating several Federal labor laws in its effort to crush an organizing drive at its Twinsburg, Ohio, facility. “It seemed that they were targeting the minority workers” said Al Mixon, Secretary-Treasurer, Teamsters Local 507, in Cleveland.

2. **Unsustainable speed-up.** Workers are stretched to do more with less, without being able to cooperate on solutions.

3. **Stream of warehouse closures.** Unionized and nonunionized warehouses are being shuttered, with more than 1,400 warehouse jobs lost across the United States in 12 months. Overall we estimate U.S. Foodservice has shed more than 10 percent of its workforce in 3 years.\(^11\)

4. **Management turmoil.** KKR and CD&R are faced with a management crisis. U.S. Foodservice CEO, Charles Aiken suddenly resigned in December of 2009. KKR and CD&R have not replaced him as of the date of this testimony. According to one U.S. Foodservice worker: “As it stands now, the worst enemy U.S. Foodservice drivers have in trying to do their jobs is the management themselves. Daily, I try to bring order out of the chaos that comes from routing, loads, and unsafe working conditions.”

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\(^7\) “Royal Ahold to Sell U.S. Foodservice Unit”. Ylan Q. Mui. 11-7-06. Washington Post.


Conclusion: Financial Reform Legislation

Under current law, private investment vehicles such as hedge funds, leveraged-buyout and venture-capital funds function with virtually no oversight. Despite managing trillions of dollars and employing millions of Americans, they operate as a shadow financial system—free to make enormous bets in secret. Comprehensive regulation of private investment funds is essential to prevent the buildup of systemic risks and to protect investors.

The Teamsters Union supports increased transparency and comprehensive regulation for all private investment funds—including hedge funds, private equity and venture capital funds, and fund managers. It is essential that the SEC have access to information about private investment funds and the authority to require them to provide disclosures to investors, prospective investors, trading partners, and creditors.

The Teamsters Union supports H.R. 4173, the Wall Street Reform and Consumer Protection Act, and S. 3217, the Restoring American Financial Stability Act.