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April 14, 2017

To: Chairman Sen. Mike Crapo, Ranking Member Sen. Sherrod Brown
Fr: Public Citizen
Re: Proposals for Economic Growth:

1. **SEC Office of Employee Advocate**
2. **Restore Glass Steagall**

Below, please find two proposals that Public Citizen advances in responses to the committee's invitation. We welcome the committee's exercise and trust that the ideas proffered will receive fair consideration. Broadly, we think that the measure of financial legislation should be the creation of good jobs and a growing, sustainable, equitable economy. We do not believe that removing prudential safeguards and reducing consumer protections meets this goal.

For questions, please contact Bartlett Naylor, financial policy advocate, at bnaylor@citizen.org.

1. SEC Office of Employee Advocate

Brief description

Public Citizen proposes an SEC Office of Employee Advocate. This Office, and an associated advisory committee, would explore and advance policies to promote the contributions of employees to company growth. It would support employees who are also investors in the firm, a potent combination whereby the productivity of workers is rewarded.

The AFL-CIO also supports this proposal.

In developing this initiative, we have worked with the office of Sen. Jack Reed.

Background

There is no constituency more interested in economic growth than the employee. Every federal candidate claims their policies will create jobs, as that's what voters want. Most legislation bearing on the economy is justified as job-creating. A good example is the most recent SEC-related law, which while aimed at

capital formation, is titled the JOBS Act.[1] Yet despite this job creation focus, the Securities and Exchange Commission, which oversees the fair intermediation from savers to users of capital in the form of securities, often finds itself tip-toeing around the interests of employees, who, of course, have a direct role on jobs.

To address this, we propose the creation of an Office of Employee Advocate. This Office would explore and promote the interests of employees, including employees who are investors.

Many American employees are also investors. And many investors are also employees.

For some, employee investment comes through compensation in the form of securities and options.[2] Such plans are designed specifically to align the incentives of employees with the profitability of the firm.

More than 10 million employees own stock in their employer's firm, either through ESOPs, or where the employer is an investment option in a 401(k) plan ("KSOP").[3] More than 50 million American workers participate in 401(k) investment plans, which hold more than $4 trillion in assets.[4] Employees may also invest directly in their place of business through Individual Retirement Accounts (IRAs). IRAs hold $7.5 trillion in assets and are held by 42 million households. [5] The interest of the employee/investor encompasses both a sizeable portion of the population and of the investment market itself. Just as individuals interested in a clean environment or healthy products may apply this mindset through socially responsible investing, an employee investor presumably brings concerns about their own workplace—compensation, workplace conditions, training, advancement potential—when making the decision to invest in their (or any) place of employment. The employee investor focus inevitably shapes a great deal of the market. Intuitively, the collective interests of employees when marshalled through investment decisions holds the promise of substantial benefit for more sustainable, equitable economic growth.

Economic Impact

Promoting employee interests promotes the economy. Firms with superior human capital management (HCM) enhance company performance and share value.[6] A survey of 36 studies on the value of training found that 22 showed a correlation with superior investment outcomes. (One did not and the balance of the studies yielded mixed results.[7])

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[1] The acronym stands for Jumpstart Our Business Startups, with job creation implicit.

[2] *EBRI Data Book on Employee Benefits*, EMPLOYEE BENEFITS RESEARCH INSTITUTE (website visited April 6, 2017) https://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2005.pdf

[3] *ESOPs by the Numbers,* NATIONAL CENTER FOR EMPLOYEE OWNERSHIP (website visited April 3, 2017), http://www.nceo.org/articles/esops-by-the-numbers

[4] *Frequently Asked Questions about 401(k) Plans*, INVESTMENT COMPANY INSTITUTE (website viewed March 27, 2017) https://www.ici.org/policy/retirement/plan/401k/faqs_401k

[5] *The Role of IRAs in Household Finance*, INVESTMENT COMPANY INSTITUTE (website viewed March 27, 2017) https://www.ici.org/pdf/per23-01.pdf

[6] See, for example, Beeferman, Bernstein "*The Materiality of Human Capital to Corporate Financial Performance*" IRRC AND THE KENNEDY SCHOOL (April 2015) http://www.law.harvard.edu/programs/lwp/pensions/publications/FINAL%20Human%20Capital%20Materiality%20April%2023%202015.pdf.

[7] Lee, Michael Byungnam; Yong-Hee Chee. 1996. Business strategy, participative human resource management and organizational performance. The Case of South Korea. Asia Pacific Journal of Human Resources, 34(1). The authors suggested that the results should be interpreted with caution because of the small sample size.

In some fields, the value of the firm is nearly synonymous with the nature of the workforce. From professional sports teams to bio-engineering, the expertise of the workforce is paramount.

The potential for improved HCM in turn enhancing the greater economy is substantial. HCM success is an intangible asset, not recorded on the company's balance sheet. When the Financial Accounting Standards Board (FASB) last addressed this issue of valuing intangible assets, it noted, "The market value... of US publicly traded companies was five time larger than their balance sheet value... thus, about 3/4 of the value of public companies, as perceived by investors, reflects nonphysical and nonfinancial assets. Much of this huge value constitutes intangibles that are absent from the balance sheet."[8] This means that intangible assets such as HCM account for the lion's share of a firm's true value. Given that the only disclosure about employees required by the SEC is the number employed at the firm, specific issues about HCM may account for a substantial portion of that value. Effective employees with institutional knowledge are valuable and difficult to replace Indeed, it is now cliché that firms declare that their employees are their most valuable asset.

Promoting employee interests, especially through employees who are investors at the firm, holds considerable promise.

At the same time, the market suffers many glaring employee-related inefficiencies. Runaway executive pay, for example, siphons money that might be reinvested in the firm such as through skills development and better compensation for employees (that, in turn, could produce more revenue). Many mergers prove to be mistakes, both to investors as promised synergies fail to manifest and to employees who lose their jobs, doubly worse when they are both employees and investors. Offshoring jobs at one firm not only harms the domestic job numbers at that firm, but also morale. It further harms the investment in other firms that no longer supply goods and services following the offshoring of jobs. Stock buybacks may serve more to manipulate share prices to advantage senior management stock options when the capital might be better deployed grow the enterprise, which may include investment in the workforce.

To date, however, the SEC does not formally recognize the specific interest of the employee and employee investor within its mandate, despite the size and financial holdings of this demographic.

The original and primary mandate of the SEC is investor protection. In 1966, the National Securities Markets Improvement Act added the mandate to facilitate capital formation. The SEC's mandates of promoting investor protection and capital formation ideally should work in unison towards a transparent market where investors are treated fairly lubricates capital formation, as investors trust disclosures, etc.[9] The cost of capital in a fair and transparent market would be cheaper as investors demand a lower risk premium.[10] These mandates, however, also find themselves in tension. For example, the JOBS Act contains a number of exemptions from investor protection that are meant to relax the regulatory

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[8] Baruch Lev "*Intangible Assets: Concepts & Measurements*" NYU ENCYCLOPEDIA OF SOCIAL MEASUREMENT, VOL 2 (2005) p 299. Available at: http://raw.rutgers.edu/docs/intangibles/Papers/Intangible%20Assets%20Concepts%20and%20Measurements.pdf.

[9] Luigi Guiso, Paola Sapienza, and Luigi Zingales, "*Trusting The Stock Market*," 63 THE JOURNAL OF FINANCE, No. 6 (Dec. 2008), available at http://www.kellogg.northwestern.edu/faculty/sapienza/htm/trusting_stock.pdf. ("The decision to invest in stocks requires not only an assessment of the risk–return trade-off given the existing data, but also an act of faith (trust) that the data in our possession are reliable and that the overall system is fair.")

[10] See George A. Akerlof, "*The Market for 'Lemons': Quality Uncertainty and the Market Mechanism,*" THE QUARTERLY JOURNAL OF ECONOMICS (August 1970).

requirements for smaller businesses. In other words, investor protection is sometimes deprioritized and reduced in the service of capital formation.

Congress emphasized its concern for capital formation for small businesses with the creation of the Office of Small Business Advocate. As with the employee investor, the interests of the investor and the small business entrepreneur can be symbiotic, as promising entrepreneurs help bring profitable ideas to investors. Where these interests diverge, this newly created office is challenged to find solutions, which may include finding balance.

So, too, an Office of Employee Advocate could harness the native interests of employees in a growing economy and with their interest as investors in that same goal. Where there are tensions, these should not be ignored, but analyzed for opportunities and potential economic growth.

We envision the following examples for areas where the Office of Employee Advocate can advance research and policy recommendations and be an effective advocate for the employee constituency:

Human Capital Management: The only disclosed metric the SEC requires regarding the workforce is the number of employees. Any investor would be informed by more granular information, such as the balance of full-time, part-time and seasonal workers. Metrics could include recruitment costs, applications per position, investment in workforce training, and promotion rates. There should also be mandatory information about violations, fines, and work stoppages. Disclosures about benefits can be illuminating to an investor. For example, one study about the clothing maker Patagonia by Rose Marcarioi found that on-site child care paid for itself in reduced absenteeism.[11]

Recruiting, training and retaining talented individuals are other important areas for improved disclosure. In technology firms, ongoing training is important for firms to develop state-of-the-art products in a field fiercely competitive. Automobiles now depend on computers, requiring similarly well trained employees.

In the end, shareholders depend on the firm's ability to attract, retain and continually train a workforce that serves as the core value of the enterprise.

The Office can help the SEC with improved disclosures in these and other areas of interest to the employee investor.

Merger & Acquisition Disclosure: Along with real property, mergers involve the addition and subtraction of employees to the resulting combination. One of the core justifications for a merger is the creation of a new firm that can produce greater collective revenue with less collective expense. This often means fewer employees, typically at the firm being acquired. Yet most mergers fail. A Harvard Business Review survey put the failure rate at between 70 and 90 percent.[12]

"Look, company A buying company B is really buying people," says Martin Sikora, editor of *Mergers & Acquisitions: The Dealmaker's Journal.* "You need to realize that and be aware that certain issues exist."

[11] Rose Marcario, "*Patagonia's CEO Explains How to Make On-Site Child Care Pay for Itself*" FAST COMPANY (August 15, 2016). Available at: https://www.fastcompany.com/3062792/second-shift/patagonias-ceo-explains-how-to-make-onsite-child-care-pay-for-itself.

[12] Clayton Christiansen et al, *The Big Idea: The New M&A Playbook*, HARVARD BUSINESS REVIEW (March 2011) https://hbr.org/2011/03/the-big-idea-the-new-ma-playbook

Negative outcomes — such as employee layoffs for the target company — are "invariable" and "must be handled humanely."[13]

Despite the critical role of employees in mergers, despite the failure of mergers that must, at least in part, stem from mismanagement of employee issues, little information is required about this area in required merger disclosure documents. In 2000, the SEC relaxed restrictions on firms communicating with employees during takeovers, but it did not mandate detailed explanations.[14]

The Office of the Employee Advocate could explore needed additional disclosures and ways of sharing information with employees. Workforce reductions by an acquiring firm would be valuable information for employees as investors when they weigh voting on the transaction. More broadly, given the central role of employees in a transaction, an employee investor would be interested in how the firm plans to reconfigure operations generally as a function of its impact on the bottom line, which would undoubtedly involve workforce reassignments or altered responsibilities.

Retrospectively, the Office could study a sample of mergers to compare how estimated cost savings and synergies compare with actual results. If employees are the most valuable asset, but this value is difficult to measure, the Office could compare the estimates with outcomes. Such an examination could prove useful broadly and help merger decisions become rooted better in sound analysis.

Corporate Governance: Employee investors may bring a unique perspective to corporate governance. The recent case of Wells Fargo dramatized the disparity between line worker conditions and senior pay. Customer-facing employees in the Community Bank division endured account creation quotas so onerous that the company suffered 30 percent annual workforce turnover, in part, from employees who didn't meet the goals. Others fabricated accounts and some 5,300 were terminated.[15] Until uncovered, the rising account figures led to a rising stock price and were used to justify generous payouts for senior management. Employees, some of whom were Wells Fargo investors, naturally understood this problem from the beginning. Some brought the issue to the attention of management, including at annual meetings, such as in the form of petitions.

A report overseen by the independent directors of Wells Fargo revealed a break down in how the board learned of the problem. While various legal, risk and audit divisions exchanged reports about problems such as employees terminated for falsifying accounts for more than a decade, these reports failed to reach the board level until 2014. In fact, it was a *Los Angeles Times* report, not any of these internal reports, that actually prompted board attention.[16]

The Wells Fargo episode addresses a serious, perhaps even criminal case. But less severe problems that deserve board attention may be common at many firms.

[13] Knowledge@Wharton, *Why Do So Many Mergers Fail*, WHARTON BUSINESS SCHOOL (March 30, 2005) http://knowledge.wharton.upenn.edu/article/why-do-so-many-mergers-fail/
[14] Final Rule: Regulation of Takeovers and Security Holder Communications, SECURITIES AND EXCHANGE COMMISSION, (Jan. 24, 2000) https://www.sec.gov/rules/final/33-7760.htm
[15] Shearman & Sterling, *Sales Practice Investigation Report,* INDEPENDENT DIRECTORS OF WELLS FARGO (April 10, 2017) https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf
[16] Shearman & Sterling, *Sales Practice Investigation Report,* INDEPENDENT DIRECTORS OF WELLS FARGO (April 10, 2017) https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf

Best practices in corporate governance likely coincide with what serves the employee investor. For example, it is best practice for the chair of a company's board to be independent, and not also serve as the firm's CEO. It is problematic for outside shareholders to bring management problems to a chair when that person is also the CEO. It is especially so when that shareholder is also an employee in the line of supervision under the CEO.

Identifying qualified board directors is also vital to employee investor interests. A board populated with directors who are poorly qualified or who do not actively oversee management doubly jeopardizes the employee investor. One of the more promising opportunities for reform is "proxy access," where shareholders can nominate directors. Directors bear important responsibilities, yet shareholders have effectively no choice in annual director elections, as there are invariably as many nominees as there are board seats. A more open election, with two or more candidates competing for a board seat, can attract more zealous, dedicated directors.

Boards could also include employee investors themselves. Germany's experience with "codetermination," where employees participate in key decisions along with shareholders, represents another area for consideration.

The Office can explore how the voice of the employee and employee investor can be amplified through improved corporate governance.

Pay disparity at firms. Income inequality hurts growth. Faced with high turnover, Henry Ford increased wages. With more experienced workers, Ford was also able to make production more efficient, allowing the company to reduce the price of his automobiles. The combination of better paid workers and more efficient production meant his own workforce could purchase the automobiles. He is credited with creating the modern middle class. This experiment in greater income equality generally is linked to overall economic growth. An authoritative study by the International Monetary Fund finds that growth over the business cycle of roughly five years is slower and shorter in duration in advanced economies where net income inequality is higher.[17] That's because consumption stagnates when income stagnates for the majority, and consumption by higher income quintiles does not compensate.[18] Instead, savings builds up in this high wealth quintile, which inflates asset prices. That can lead to negative wealth, that is, when lower income consumers use debt. AFL-CIO economist Prof. William Spriggs explores these concepts in recent testimony before the Senate Banking Committee. [19]

This inequality is manifest at major companies, where executive pay has soared, while median pay has remained flat for decades. According to the Economic Policy Institute, "CEO pay grew an astounding 943% over the past 37 years, greatly outpacing the growth in the cost of living, the productivity of the economy, and the stock market, disproving the claim that the growth in CEO pay reflects the 'performance' of the company, the value of its stock, or the ability of the CEO to do anything but disproportionately raise the amount of his pay." This escalation, both for CEOs and senior managers generally, has skewed revenue toward senior pay. For example, at JP Morgan, more than 2,000 employees

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[17] Jonathan D. Ostry, Andrew Berg, and Charalambos G. Tsangarides, "*Redistribution, Inequality, and Growth*," IMF STAFF DISCUSSION NOTE, SDN/14/02 (February 2014) at https://www.imf.org/external/pubs/ft/sdn/2014/sdn1402.p

[18] Lower income consumers spend a larger share of their income than do higher income people. Higher income people may save and invest, but ultimate, there must be consumers for the products of firms where these savings and investment dollars go.

[19] William Spriggs, *Fostering Economy Growth,* SENATE BANKING COMMITTEE (March 28, 2017) https://www.banking.senate.gov/public/_cache/files/7a003f29-83dc-4577-bb26-cd5d01e00a97/94A94A2E31322EBCAD78BF365936B907.spriggs-testimony-3-28-17.pdf

are paid more than $1 million annually. Yet tellers at the same firm receive modest wages. In fact, one third of bank tellers nationwide receive government assistance.[20] According to a report by As You Sow, an advocacy group promoting the environment and social corporate responsibility, one conduit for this asymmetry comes through dysfunctions in proxy voting. Where employee investors might oppose excessive senior executive compensation plans, the report found that mutual funds—where employees-as-clients rely on the mutual fund manager to vote—reflexively support senior compensation plans.[21]

The Office of the Employee Advocate can study ways to strengthen the voice of employee investors. For example, it might recommend that mutual fund manager survey clients on basic proxy voting issues such as executive compensation or new proxy issues such as political spending disclosure or tax disclosure. Because senior managers select mutual funds, the fund may be reluctant to adopt policies conflicting with manager interests, even though the fund assets are owned by employees.

Buybacks. The 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012 used 54% of their earnings—a total of $2.4 trillion—to buy back their own stock, almost all through purchases on the open market, according to a study by William Lazonick of the University of Massachusetts. "That left very little for investments in productive capabilities or higher incomes for employees." [22] Corporate executives may attempt to justify buybacks as returning funds to shareholders when they cannot find better ways to invest the capital in the firm to generate greater profits. If this were true, then buybacks would tend to occur at a time when share prices are relatively low. Continuing shareholders naturally wish the company to spend less per share than more, as with any spending. In fact, many buybacks occur when the share price is relatively high. Companies that sell the stock when it is relatively high feed criticism that buybacks actually serve another purpose.

Critics contend the real goal of buybacks is to boost the share price around the time that managers can exercise stock options. For the three decades ending in the late 1970s, Lazonick reflects that a retain-and-reinvest prevailed at major U.S. corporations. "They retained earnings and reinvested them in increasing their capabilities, first and foremost in the employees who helped make firms more competitive. They provided workers with higher incomes and greater job security." After a period of frenzied merger activity, decline in unionization, and a little noticed rule change at the SEC known as 10b-18, (which insulates management from market manipulation charges provided the amount of daily purchases does not exceed 25 percent of the previous four weeks' average daily trading volume), the era of the buyback began. Consistent purchases at this maximum amount could affect the share price. Since firms report company purchases on a quarterly basis, it is not clear from daily stock price changes if a company repurchase is involved. Only a special SEC investigation could identify true manipulation.

Additionally, extensive buybacks may also be correlated with layoffs. For example, according to MarketWatch report, during one two day period in 2015, a half dozen companies simultaneously

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[20] Sherrod Brown, Opening statement, "Fostering Economic Growth," SENATE BANKING COMMITTEE, (March 28, 2017), https://www.banking.senate.gov/public/index.cfm/hearings?ID=EAD8370F-249E-4E65-B9BD-3C6352736E38

[21] Rosanna Landis Weaver*, Are Fund Managers Asleep at the Wheel*, AS YOU SOW, (February 2017) http://www.asyousow.org/ays_report/the-100-most-overpaid-ceos-are-fund-managers-asleep-at-the-wheel/

[22] William Lazonick, Profits without Prosperity, Harvard Business Review (September 2014) https://hbr.org/2014/09/ profits-without-prosperity

announced layoffs and buybacks, including Perrigo, Caterpillar, 3M, Dow Chemical, and Biogen.[23] Others have noticed this issue, including those on Capitol Hill, where Senator Joe Donnelly (D-Ind) has focused attention on the potential connections between United Technologies buybacks and a decision to offshore jobs at its Carrier division in his state as an area of concern. [24]

A new SEC Office can better examine the legitimacy of buybacks, and potentially recommend reforms like changes to Rule 10b-18. Further, the Office could explore whether offshoring jobs produces true value to the firm. While worker pay may be lower in developing countries, quality may be sacrificed.

Conclusion

In summary, the potential for achieving economic growth through policy reforms following research and advocacy by the Office of the Employee Advocate are clear. Concludes Sue Holmberg, economist and fellow at the Roosevelt Institute, “Treating workers as essential stakeholders-as American companies once did during the "Great Prosperity" between WW2 and the early 1970s-is good for the long-term viability of businesses and the economy at large. The Office of Employee Advocate is a crucial step in building strong stakeholder relationships and ensuring resilience and growth in the American economy.”[25] Given the central role of the employee in the economy, it is axiomatic that policies that improve job creation, human capital management, more sensible treatment of buybacks and other areas with contribute generally to economic growth.

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[23] Phillip van Doorn, *Companies are Wasting Money from Layoffs and Share Buybacks,* MARKETWATCH(Oct. 28, 2015) http://www.marketwatch.com/story/tis-the-season-for-companies-to-lay-off-workers-and-buy-back-shares-2015-10-23

[24] Carrier is a Good Start, OFFICE OF SEN. JOE DONNELLY, (website visited April 3, 2017) https://www.donnelly.senate.gov/newsroom/press/donnelly-to-trump-carrier-is-good-start

[25] Sue Holmberg, email to Public Citizen (April 13, 2017) available upon request.

Legislative language

Title: To amend the Securities Exchange Act of 1934 to establish an Office of the Employee Advocate and an Employee Advisory Committee, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "SEC Employee Advocate Act of 2017".

SEC. 2. ESTABLISHMENT OF THE OFFICE OF THE EMPLOYEE ADVOCATE AND THE EMPLOYEE ADVISORY COMMITTEE.

(a) Office of the Employee Advocate.—Section 4 of the Securities Exchange Act of 1934 (15 U.S.C. 78d) is amended by adding at the end the following:

"(k) Office of the Employee Advocate.—

"(1) Definitions.—In this subsection, the terms 'covered employee', 'employee', 'individual retirement plan', and 'IRA holder' have the meanings given the terms in section 41(a).

"(2) Office established.—There is established within the Commission the Office of the Employee Advocate (in this subsection referred to as the 'Office').

"(3) Employee advocate.—

"(A) In general.—The head of the Office shall be the Employee Advocate, who shall—

"(i) report directly to the Commission; and

"(ii) be appointed by the Commission, from among individuals having experience in advocating for the interests of covered employees and IRA holders.

"(B) Compensation.—The annual rate of pay for the Employee Advocate shall be equal to the highest rate of annual pay for other senior executives who report directly to the Commission.

"(C) No current employee of the commission.—An individual may not be appointed as the Employee Advocate if the individual is employed by the Commission as of the date on which the appointment is made.

"(4) Staff of office.—The Employee Advocate, after consultation with the Commission, may retain or employ independent counsel, research staff, and service staff, as the Employee Advocate determines to be necessary to carry out the functions of the Office.

"(5) Functions of the employee advocate.—The Employee Advocate shall—

"(A) ensure that the Commission or a self-regulatory organization considers the interests of—

"(i) covered employees when the Commission or a self-regulatory organization makes or proposes to make a decision affecting an entity that employs covered employees;

“(ii) IRA holders when the Commission or a self-regulatory organization makes or proposes to make a decision affecting an entity—

“(I) in which IRA holders are invested; or

“(II) that makes individual retirement plans available to employees; and

“(iii) employees;

“(B) assist employees and retired employees—

“(i) who are covered employees if an entity that employs or employed such covered employees, as applicable, is impacted by an action taken or proposed to be taken by the Commission or a self-regulatory organization;

“(ii) who are IRA holders if an entity that makes or made individual retirement plans available to the employees or retired employees of the entity, as applicable, is impacted by an action taken or proposed to be taken by the Commission or a self-regulatory organization; and

“(iii) when an entity that employs or employed the employees, as applicable, takes an action that—

“(I) could come before the Commission, including a merger and an acquisition; and

“(II) impacts covered employees;

“(C) where appropriate, identify means to—

“(i) promote greater awareness of shareholder rights;

“(ii) encourage more effective participation in corporate governance by covered employees and IRA holders; and

“(iii) improve retirement security;

“(D) identify methods to measure and promote the benefits that employees contribute to investor value;

“(E) analyze the potential impact of proposed regulations of the Commission that are likely to have a significant economic impact on employees, covered employees, and IRA holders;

“(F) conduct outreach to employees, covered employees, and IRA holders, including through regional meetings and discussions, in order to solicit views with respect to issues relating to employees, covered employees, IRA holders, and investors;

“(G) to the extent practicable, propose to the Commission changes in the regulations or orders of the Commission, and to Congress any legislative, administrative, or personnel changes, that may be appropriate to—

“(i) mitigate any problems identified under this paragraph; and

“(ii) promote the interests of employees, covered employees, and IRA holders;

“(H) consult with the Advocate for Small Business Capital Formation and the Investor Advocate on any proposed changes made under subparagraph (G); and

“(I) advise the Advocate for Small Business Capital Formation and the Investor Advocate on issues relating to actions proposed or taken by the Commission that impact employees, covered employees, and IRA holders.

“(6) Access to documents.—The Commission shall ensure that the Employee Advocate has full access to the documents and information of the Commission and any self-regulatory organization, as necessary to carry out the functions of the Office.

“(7) Annual report on activities.—

“(A) In general.—Not later than December 31 of each year beginning in 2018, the Employee Advocate shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report on the activities of the Employee Advocate during the immediately preceding fiscal year.

“(B) Contents.—Each report required under subparagraph (A) shall include—

“(i) appropriate statistical information and full and substantive analysis;

“(ii) information on steps that the Employee Advocate has taken during the reporting period to ensure that the Commission, when making decisions, considers the needs and concerns of employees, covered employees, and IRA holders;

“(iii) a summary of the most serious issues encountered by employees, covered employees, and IRA holders;

“(iv) an inventory of the issues summarized under clause (iii), including any issue summarized under that clause for any prior reporting period—

“(I) on which no action has been taken; or

“(II) that has not been resolved to the satisfaction of the Employee Advocate as of the beginning of the period covered by the report;

“(v) with respect to an issue described in subclause (I) or (II) of clause (iv)—

“(I) identification of any action taken by the Commission or a self-regulatory organization and the result of the action;

“(II) the length of time that each issue has remained on the inventory; and

“(III) for an issue with respect to which no action has been taken—

“(aa) the reasons for the inaction; and

“(bb) an identification of any official who is responsible for taking action;

“(vi) recommendations for any changes to the regulations, guidance, and orders of the Commission, or any legislative changes, that may be appropriate to resolve problems with the Commission and self-regulatory organizations encountered by employees, covered employees, and IRA holders; and

“(vii) any other information, as determined appropriate by the Employee Advocate.

“(C) Confidentiality.—No report required under subparagraph (A) may contain confidential information.

“(D) Independence.—Each report required under subparagraph (A) shall be provided directly to the committees of Congress listed in that subparagraph without any prior review by or comment from the Commission, any commissioner, any other officer or employee of the Commission, or the Office of Management and Budget.

“(8) Regulations.—The Commission shall establish procedures that require the Commission to issue a formal response to all recommendations submitted to the Commission by the Employee Advocate not later than 90 days after the date on which the Employee Advocate makes the submission.

“(9) Rule of construction.—Nothing in this subsection may be construed as replacing or reducing the responsibilities of the Advocate for Small Business Capital Formation or the Investor Advocate.”.

(b) Employee Advisory Committee.—Title I of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following:

“SEC. 41. EMPLOYEE ADVISORY COMMITTEE.

“(a) Definitions.—In this section—

“(1) the term ‘Committee’ means the Employee Advisory Committee established under subsection (b);

“(2) the term ‘covered employee’ means a participant in—

“(A) a security-based employee compensation plan; or

“(B) an employee pension benefit plan;

“(3) the term ‘employee’ means an employee of an entity that could be affected by a decision made or proposed to be made by the Commission or a self-regulatory organization;

“(4) the terms ‘employee pension benefit plan’ and ‘participant’ have the meanings given the terms in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002);

“(5) the term ‘individual retirement plan’ has the meaning given the term in section 7701(a) of the Internal Revenue Code of 1986;

“(6) the term ‘IRA holder’ means an employee who has an individual retirement plan;

“(7) the term ‘labor organization’ has the meaning given the term in section 7103(a) of title 5, United States Code; and

“(8) the term ‘security-based employee compensation plan’ means an equity compensation plan, including stock options, stock appreciation rights, restricted stock, and a stock unit plan, that is subject to the jurisdiction of the Commission.

“(b) Establishment and Functions.—

“(1) Establishment.—There is established within the Commission the Employee Advisory Committee.

“(2) Functions.—The Committee shall provide the Commission with advice on the rules, regulations, and policies of the Commission with respect to the mission of the Commission of—

“(A) protecting investors (and, in particular, with respect to protecting covered employees and IRA holders);

“(B) protecting employees; and

“(C) maintaining fair, orderly, and efficient markets.

“(c) Membership.—

“(1) In general.—The members of the Committee shall be—

“(A) the Employee Advocate;

“(B) not fewer than 10, and not more than 20, members appointed by the Commission, from among—

“(i) individuals who represent employees, covered employees, and IRA holders; and

“(ii) professional advisors, including attorneys, accountants, investment bankers, and financial advisors—

“(I) of entities that—

“(aa) employ covered employees; and

“(bb) make individual retirement plans available to employees; and

“(II) that advise employees, covered employees, and IRA holders; and

“(C) 4 non-voting members—

“(i) 1 of whom shall be appointed by the Investor Advocate;

“(ii) 1 of whom shall be appointed by the Advocate for Small Business Capital Formation;

“(iii) 1 of whom shall be appointed by the Employee Advocate in consultation with labor organizations; and

“(iv) 1 of whom shall be appointed by the Assistant Secretary for Employee Benefits Security of the Department of Labor.

“(2) Term.—Each member of the Committee appointed under subparagraph (B) or (C) of paragraph (1) shall serve for a term of 4 years.

“(3) Members not commission employees.—A member of the Committee appointed under subparagraph (B) or (C) of paragraph (1) shall not be treated as an employee or agent of the Commission solely because of membership on the Committee.

“(4) Limitation.—The number of members of the Committee appointed under paragraph (1)(B)(ii) shall be not more than \1/4\ of the total number of members of the Committee.

“(d) Chair; Vice Chair; Secretary; Assistant Secretary.—

“(1) In general.—The members of the Committee shall elect, from among the members of the Committee—

“(A) a chair;

“(B) a vice chair;

“(C) a secretary; and

“(D) an assistant secretary.

“(2) Term.—Each member elected under paragraph (1) shall serve for a term of 3 years in the capacity for which the member was elected under paragraph (1).

“(e) Meetings.—

“(1) Frequency of meetings.—The Committee shall meet—

“(A) not less frequently than 4 times annually, at the call of the chair of the Committee; and

“(B) from time to time, at the call of the Commission.

“(2) Notice.—The chair of the Committee shall give the members of the Committee written notice of each meeting, not later than 14 days before the date of the meeting.

“(f) Compensation and Travel Expenses.—Each member of the Committee who is not a full-time employee of the United States shall—

“(1) be entitled to receive compensation at a rate not to exceed the daily equivalent of the annual rate of basic pay in effect for a position at level V of the Executive Schedule under section 5316 of title 5, United States Code, for each day during which the member is engaged in the actual performance of the duties of the Committee; and

“(2) while away from the home or regular place of business of the member in the performance of services for the Committee, be allowed travel expenses, including per diem in lieu of subsistence, in the same manner as persons employed intermittently in the Government service are allowed expenses under section 5703 of title 5, United States Code.

“(g) Staff.—The Commission shall make available to the Committee such staff as the chair of the Committee determines is necessary to carry out this section.

“(h) Review by Commission.—The Commission shall—

“(1) review the findings and recommendations of the Committee; and

“(2) each time the Committee submits a finding or recommendation to the Commission, promptly issue a public statement—

“(A) assessing the finding or recommendation of the Committee; and

“(B) disclosing the action, if any, the Commission intends to take with respect to the finding or recommendation.

“(i) Recusal in Cases of Financial Conflict.—The Committee shall establish procedures to prohibit a member of the Committee from participating in the consideration of any matter in which the member has a financial conflict of interest.

“(j) Federal Advisory Committee Act.—The Federal Advisory Committee Act (5 U.S.C. App.) shall not apply with respect to the Committee and the activities of the Committee.”

2. **Restore Glass-Steagall**

Brief description

Public Citizen supports the adoption of a 21st Century Glass-Steagall, as drafted and introduced by committee member Sen. Elizabeth Warren. This measure would restore the basic separation between commercial banking, which directs deposits backed by the government Federal Deposit Insurance Corporation (FDIC) into loan-making, and investment banking, which includes derivatives trading.

We incorporate by reference the legislative language in S 881.[26]

Background

Congress responded to the Wall Street crash in 1929 with a series of laws passed in 1933, including the National Banking Act, known as "Glass-Steagall." This act established a federal deposit guarantee for the loans given to banks from depositors. But Congress also decided that banks should constrain their risk-taking to loan-making to customers such as businesses and home buyers. The 1933 act banned banks with FDIC-insured deposits from engaging in riskier, socially dubious activities associated with the financial crash of 1929. The Independent Community Bankers of America (ICBA), consisting of more than 5,000 member banks, articulated the policy rationale behind this division as recently as 2013: "Banks are accorded access to federal deposit insurance and liquidity facilities because they serve a public purpose: facilitating economic growth by intermediating between savers and borrowers."[27]

Although the banking industry had naturally resisted the 1933 legislation, selling off their securities businesses did not deprive the firms of substantial income immediately because the 1929 crash had soured America's interest in stocks. As interest in investing reawakened in the aftermath of World War II, regulatory and court decisions gradually eroded the firewall between commercial and financial services, such as between investment banking and insurance. Money market funds and brokerage firms such as Merrill Lynch began offering checking account services. Commercial banks increasingly lost market share to other financial institutions.

Pressure grew from commercial banks to allow them greater flexibility to compete. In the 1980s, the Comptroller of the Currency, which regulates national banks, allowed commercial banks to engage in derivatives activity.[28] Regulators approved additional powers for traditional commercial banks. In 1989, the Federal Reserve permitted JP Morgan to underwrite a certain volume of corporate bonds. Around the same time, regulators allowed commercial banks to offer a wide variety of insurance, securities and investment-related services through subsidiaries. On the other side of the street, brokerage firms found loopholes to own bank subsidiaries under certain conditions. In 1998, Citicorp, with the help of a temporary exemption from the Glass-Steagall prohibition on mixing banking with insurance, merged with the giant

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[26] Sen. Elizabeth Warren, et al, *21st Century Glass Steagall Act,* S 881, UNITED STATES SENATE (April 2017) https://www.congress.gov/bill/115th-congress/senate-bill/881?q=%7B%22search%22%3A%5B%2221st+century+glass+steagall%22%5D%7D&r=1

[27] Comment from Independent Community Bankers of America to Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Commodities Futures Trading Commission, and Securities and Exchange Commission re: The Volcker Rule, (Feb. 13, 2012) . http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021312_104966_451638070183_1.pdf

[28] Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking"*, 63 UNIVERSITY OF MIAMI LAW REVIEW 1041 (2009), http://bit.ly/1OFHEuR.

insurance firm Travelers Group to form Citigroup.[29] Then Congress ratified this merger when it approved the Gramm-Leach-Bliley Financial Services Modernization Act of 1999. This formally repealed the Glass-Steagall firewall. This punctuation to the end of Glass-Steagall most conspicuously provided the main provision that Citigroup sought, namely housing banking and insurance underneath one corporate roof.

Nine years later, in 2008, the financial system collapsed. Complex investments involving mortgages packaged as mortgage-backed securities, which were widely held by both commercial and investment banks, proved rotten. Derivatives, once justified as a product to reduce risk, instead amplified risk. For example, credit default swap derivatives pay when a bond goes into default. But unlike risk hedging using fire insurance, for which the insured must own the home, a purchaser of a credit default swap need not own the bond. These are known as "naked" credit default swaps. Worse, multiple investors could make claims on the default of a single bond.

Naked credit default swaps marked an evolution in the purpose of derivatives from their traditional risk-management function to sheer gambling. When the financial crisis struck in 2008, three-to-four times as many naked credit default swaps were in circulation as were credit default swaps held by investors who owned the underlying asset. This is equivalent to many investors buying fire insurance on the same house. If one such house burned down, it might even jeopardize the insurance company, as happened to AIG. In this case, AIG's potential failure reverberated back to the firms it owned money to, such as mega-bank Goldman Sachs.[30]

Public Citizen explores these and related issues in our publication *TOO Big: The Mega-banks are Too Big to Fail, Too Big to Jail, and Too Big to Manage*, available online.[31]

<u>Economic Impact</u>

When Congress approved the repeal of Glass-Steagall, the legislative architects stopped short of promising that it would fuel economic growth. We find this notable as the Committee measures proposals based on this standard. Certainly, the 2008 crash demonstrated that the repeal law certainly did not guarantee a stable economy or growing economy.

The repeal also exacerbated the growth in derivatives trading and the anti-competitive consolidation of the financial sector.

Derivatives: Commercial bank entry into investment banking increased opportunities for risk taking. In the last few decades, this sector has become dominated by derivatives trading. The volume of existing derivatives contracts increased from $94 trillion in 1998 to more than $685 trillion by 2013.[32] Much of this growth came from commercial banks formerly prohibited from this arena. Noted former Goldman Sachs executive Wallace Turbeville, "The combination of commercial and investment banking coincided with the rise of trading driven by massive increases in trading revenues in the deregulated environment."[33] Trading and traders now ruled on Wall Street and that trading largely involved derivatives. Fortified with funds

[29] Mitchell Martin, *Citicorp and Travelers Plan to Merge,* NEW YORK TIMES, (April 7, 1998 2012), http://www.nytimes.com/1998/04/07/news/07iht-citi.t.html

[30] Taylor Lincoln, PUBLIC CITIZEN, FORGOTTEN LESSONS OF DEREGULATION, (May 2012), http://www.citizen.org/documents/forgotten-lessons-of-deregulation-derivatives-report.pdf

[31] Bartlett Naylor, *TOO Big,* PUBLIC CITIZEN (June 2016) http://www.citizen.org/documents/TooBig.pdf

[32] Juraj Lazovy, *Impact of Financial Derivatives on the Real Economy*, INTERNATIONAL JOURNAL OF MANAGEMENT EXCELLENCE (October 2014) http://www.ijmeonline.com/index.php/ijme/article/viewFile/178/76

[33] Wallace Turbeville, *Derivatives: Innovation in the Era of Financial Deregulation,* DEMOS (June 13, 2013) http://www.demos.org/publication/derivatives-innovation-era-financial-deregulation

made cheap and abundant by FDIC insurance, the major banks came to dominate trading. At the time of the crash, the largest trader was, and still is, JP Morgan, with nearly $3 trillion in assets.

Was this good for the economy? In addition to the extraordinary cost of the financial crisis, some economists have concluded that so-called innovations such as derivatives have made banking less efficient. Generally, the financial sector is supposed to match savers with users of capital, a purpose abbreviated as "intermediation." The cost of "intermediation" is the measure of the financial sector's efficiency.[34] Yet this intermediation cost measure has burgeoned, not declined. Bankers matched savers with users of capital for the construction of railroads in the 19th century, development of the automobile industry in the middle of the 20th century and innovations in pharmaceuticals and technology in the 1970s and 1980s for lower capital costs than the financial sector offers today. Computers, which have made many sectors more efficient, have not had the same impact on the financial sector despite the widespread use of the latest technology at the mega-banks.

Turbeville estimated that the cost of derivatives for a real economy partner to a bank is 10 times the cost of conventional credit.[35] Turbeville speculated that this is due to the relative lack of sophistication on the part of bank customers. NYU Prof Andrew Kalotay estimated that state and local governments were overcharged by $20 billion by the financial sector in the years between 2006 and 2010. [36]

A study on the impact of financial derivatives on the economy shows a connection between growth in this sector and rising unemployment as well as declining Gross National Product (GNP.)[37] Ultimately, any enterprise involves risk. Any entrepreneur who attempts to reduce that risk through a derivative must incur an up-front cost, which is the price of the derivative. When that cost is inflated by complexity, opacity, and an unequal playing field between banker and client, the real economy suffers. Economist Ozgur Orhangazi notes that fees paid for derivatives and other transactions "may have impeded real investment by decreasing available internal funds, shortening the planning horizons of the firm management and increasing uncertainty." [38]

Adair Turner, former chair of the UK Financial Services Authority, agrees that derivatives may be a net cost to the economy.[39]

Consolidation: Repeal of Glass-Steagall accelerated consolidation in the financial sector, a threat to competition. Instead of competing against one another to provide the best services for the lowest prices, many of these firms are now part of the same organization. That's true both among commercial banks, and among investment banks that are now joined with the commercial banks. JP Morgan owns Washington Mutual, a lender, and Bear Stearns, an investment bank. The four largest depository banks control nearly half of all the nation's deposits. This exposes consumers to rising charges, such as for ATM fees.

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[34] *See* THOMAS PHILIPPON, THE EVOLUTION OF THE US FINANCIAL INDUSTRY FROM 1860-2007: THEORY AND EVIDENCE (November 2008), http://bit.ly/1QmVIOI.

[35] Mark Gongloff, *Derivatives are a Weapon of Slow Economic Destruction,* HUFFINGTON POST, (June 14, 2013) http://www.huffingtonpost.com/2013/06/14/derivatives-weapons-destruction_n_3442229.html

[36] Wallace Turbeville, *Derivatives: Innovation in the Era of Financial Deregulation,* DEMOS (June 13, 2013) http://www.demos.org/publication/derivatives-innovation-era-financial-deregulation

[37] Juraj Lazovy, *Impact of Financial Derivatives on the Real Economy*, INTERNATIONAL JOURNAL OF MANAGEMENT EXCELLENCE (October 2014) http://www.ijmeonline.com/index.php/ijme/article/viewFile/178/76

[38] Ozgur Orhangazi, *Financialization and Capital Accumulation*, CAMBRIDGE JOURNAL OF ECONOMICS (2008) http://courses.umass.edu/econ711-rpollin/Orhangazi%20financialization%20in%20CJE.pdf

[39] Adair Turner et al, *The Future of Finance,* LONDON SCHOOL OF ECONOMICS (2010) https://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter11.pdf

Noted MIT economist Simon Johnson, restoring Glass-Steagall breaks up the mega banks. "Anything that tilts the playing field back toward smaller financial institutions is good for the small business sector."[40]

Added Cornell Prof. Saule Omarova said. "If Glass-Steagall is reinstated, then sectors compete against each other. Isn't that a better world?"[41]

Repealing Glass-Steagall also introduced the hazard that commercial banks might attempt to link their loan services for subsequent underwriting deals, at the disadvantage of smaller investment firms. While such links, or "tying arrangements" are prohibited by statute,[42] it is clear that the largest banks dominate investment banking, which may indicate factors other than simply better service or lower prices. Whistleblower Marc Wiersum alleged that U.S. Bank N.A., which was his employer, engaged in "unlawful tying arrangements," specifically conditioning credit upon asset management services.[43] US Bank is the fifth largest bank in the nation.

The Democratic Party Platform specifically notes "tying arrangements" as an area for greater enforcement.[44]

Conclusion

A 21st Century Glass-Steagall can help restore long-term stability to the economy. By reducing major bank derivatives trading unrelated to basic banking, it can reduce the drain of profits from Main Street firms to the financial sector. By reducing the size of the mega-banks, it can reduce the hazard of excessive risk-taking by banks that consider themselves "too big to fail." And it can restore needed competition to financial markets.

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[40] Simon Johnson, *Five Facts about Glass-Steagall*, BLOOMBERG (July 11, 2012) https://www.bloomberg.com/view/articles/2013-07-11/five-facts-about-the-new-glass-steagall

[41] Ryan Rainey, *The Free Market Republican's Case for Glass Steagall,* MORNING CONSULT (August 15, 2016) https://morningconsult.com/2016/08/15/conservative-case-glass-steagall/

[42] 12 U.S.C. 1972(1)

[43] Wiersum v. US Bank, US DISTRICT COURT FOR THE SOUTHERN DISTRICT OF FLORIDA (May 5, 2015) http://media.ca11.uscourts.gov/opinions/pub/files/201412289.pdf

[44] Democratic National Platform, MEDIUM (August 2016) https://medium.com/to-the-left/the-2016-democratic-party-platform-55c0e651246a