

**TESTIMONY OF DAMON A. SILVERS**  
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**TO THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**  
**ON LEGISLATIVE PROPOSALS TO EXAMINE CORPORATE GOVERNANCE**

June 28, 2018

Good morning, Chairman Crapo, Ranking Member Brown, and members of the committee. My name is Damon Silvers, and I am the Policy Director and Special Counsel for the AFL-CIO, America's labor federation representing 55 national and international labor unions and more than 12 million working people.

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

Following the financial crisis that began in 2007, it was clear that our system of financial regulation had been dangerously weakened by laws that exempted large parts of the financial system from effective regulation, and in other cases created opportunities for regulatory arbitrage. While the Dodd-Frank Act addressed many of these weaknesses, at the time of the passage of the Act investor advocates recognized there was much left to be done. Among the key issues that remained were—

- 1) How to protect effectively protect investors from the threat of self-dealing by the experts they hire to help them manage their money
- 2) How to ensure a level playing field for all investors in capital markets where information moves instantaneously and where big data means big power and big money
- 3) How to prevent the reoccurrence of the dynamic that led to the financial crisis of large parts of the financial system becoming unregulated and/or opaque?

Each of the bills under consideration in this hearing fits within these three questions. Some of these bills would productively address these challenges, others would make these challenges worse for investors.

The remainder of my testimony will address each of the bills under consideration in turn.

**H.R. 4015— Corporate Governance Reform and Transparency Act of 2017.**

The Corporate Governance Reform and Transparency Act would create a special regulatory regime for firms that advise investors on how to exercise their voting rights as stockholders. The bill claims to foster “accountability, transparency, responsiveness, and competition in the proxy advisory firm industry,” while in reality it will interfere with shareholders' access to impartial analysis and undermine shareholders' ability to hold corporate management accountable. This bill would create conflicts of interest where none now exist, and treat proxy advisory firms differently than other asset managers. Having the right to vote and exercise other corporate governance rights is at the heart of what it means to be a shareholder. Pension funds in particular have a legal duty under ERISA, the Internal Revenue Code, and state law to obtain expert, independent advice in the management of all their plan assets, including

voting rights. Pension funds and other institutional investors rely on proxy advisory firms to sort through the thousands of pages of complex financial reporting that issuers send to shareholders every proxy season. Limited time and resources makes the kind of intensive analysis performed by proxy advisory firms prohibitively difficult and costly for many institutional investors to review the massive amounts of information involved in voting proxies for large, diversified investors.

The United States Department of Treasury (Treasury) 2017 report to the President on “A Financial System that Creates Economic Opportunities, Capital Markets” found that “institutional investors, who pay for proxy advice and are responsible for voting decisions, find the services valuable, especially in sorting through the lengthy and significant disclosures contained in proxy statements.” After extensive review of the industry, Treasury did not recommend any legislative changes governing proxy advisory firms.

Despite these findings, H.R. 4015 effectively gives corporations’ CEO’s and boards the ability to control the people who are supposed to be holding them accountable. The bill would do this by enabling companies to delay vote recommendations. Corporate executives would then be able to object to any proxy voting recommendation that is contrary to their own preferences, including votes on their own executive compensation packages.

Institutional investors and associations, including the National Association of State Treasurers and the Council of Institutional Investors oppose this bill. It would increase costs for investors, compromise the quality and reliability of information, and reduce board accountability to investors.

The AFL-CIO does believe that proxy advisors should be regulated like other investment advisors, and would not oppose a requirement that they register as such. However we strongly oppose H.R. 4015 because this bill appears to punish proxy advisors for doing their job and seeks to impose upon them a regulatory scheme designed to make them disloyal to their clients, among which are our members’ pension funds.

### **S. 2756—Fair Investment Opportunities for Professional Experts Act.**

This legislation would codify the current Securities and Exchange Commission (SEC) definition of “accredited investor”. The bill defines accredited investors to include individuals or couples with a net worth of \$1 million excluding their primary residence, individuals with an income above \$200,000 in each of the last two years, or couples with a joint income above \$300,000 in each of the last two years. This effectively makes many Main Street retirement savers, particularly in high income areas, “accredited investors”.

This issue is a critical component of the way our securities laws defines public markets versus private markets. We are concerned generally that private markets have increasingly been defined in law and regulation in ways that make them essentially the same as public markets in terms of the scale of the markets and in terms of who is actually exposed to risk, but without the transparency and investor protection systems that have been built up in the public markets. S. 2756 would accelerate this trend.

This is because the definition of “accredited investor” is crucial in securities laws to determine whether a transaction qualifies for the private offering exemption from investor protection requirements. The Supreme Court limits this exemption to “to those who are shown to be able to fend for themselves.”<sup>1</sup> In other words, accredited investors are those individuals who do not need the registration and disclosure protections afforded by the Securities Act of 1933, because they would be able to evaluate potentially risky and illiquid private offerings without the investor protections provided in a public offering.

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<sup>1</sup> See: Securities and Exchange Commission v. Ralston-Purina Co.

The SEC's Investor Advisory Committee (IAC) has found that the current accredited investor definition based on financial thresholds is inadequate to protect mom and pop investors, and has opposed codifying this definition in law, instead advocating for a new rulemaking that would improve the definition to permit more sophisticated investors to access private offerings while better protecting less sophisticated retirees.<sup>2</sup> The state securities administrators (North American Securities Administrators Association, or NASAA) also oppose codifying this low net-worth threshold.<sup>3</sup>

The \$1 million asset threshold was originally set by rule in 1982 and has not been updated since then. Even with the inflation adjustments the bill requires every three years, the definition would make Main Street retirement savers "accredited investors" simply because they have saved for retirement. While we support indexing the net-worth threshold, the current baseline is far too low to act as a starting point. These individuals are often dependent on their retirement savings to survive and cannot easily recoup large investment losses.

The Fair Investment Opportunities for Professional Experts Act codifies a weakness in current investor protections and would require average retirees to be able to evaluate the risk of financial instruments as well as trained, experienced investment professionals.

For the above stated reasons, we urge you to oppose this bill.

### **S. 1744—Brokaw Act**

In 1968, Congress passed the Williams Act to require investors to publicly disclose when they accrue a large ownership stake in a public company. The purpose of the Act was to end corporate raiders' ability to make cash tender offers to shareholders without any need to disclose their identities, intentions or report anything to the SEC. The Williams Act amended the Securities Exchange Act of 1934 to require that investors file public disclosures with the SEC within 10 days of acquiring a 5 percent or more stake in a public company. In the 50 years since the Williams Act was passed, there have been substantial changes in trading activities and technology. The Brokaw Act is a necessary and timely update to the disclosures required in Section 13(d) of the Exchange Act that accounts for trading behaviors that have emerged in recent decades and market expectations related to the speed of information access.

Currently, there is a 10-day window between when an investor crosses the 5% ownership threshold of a company and when that beneficial ownership position must be disclosed with a 13-D filing. Since the Williams Act passed in 1968, evolution in information technology has created an appropriate expectation among investors that they will have access to information much more quickly. SEC disclosure forms are now filed electronically, which makes disclosure faster and easier for issuers. As a result, we believe the shorter filing window proposed in the Brokaw Act for 13-D filings is necessary and appropriate.

Empirical evidence shows an abnormally high level of trading inside of that 10-day window, which is best explained as the action of traders with knowledge of the hedge funds' positions. This trading activity is likely to be attributable to groups of sophisticated hedge fund investors, known as "wolf packs," that communicate in the period between which they begin accumulating their position and the 13-D filing is made. These groups take positions in the company with the expectation that the stock price will jump once the 13-D is filed. These "wolf packs" can currently exceed the 5% ownership threshold collectively without triggering any disclosure requirements at all.

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<sup>2</sup> See: Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014). Available at <http://bit.ly/22HoUHW>.

<sup>3</sup> North American Securities Administrators Association, "Letter from NASAA President and Alabama Securities Director Joseph P. Borg to the HFSC Chair and Ranking Member regarding markup of H.R. 3758, H.R. 477, H.R. 3857, H.R. 2201, and H.R. 1585", October 11, 2017. Available at <http://bit.ly/2xK1Lag>

Finally, activist investors can manipulate the process by secretly taking net short positions. In other words, they use their long (public) position to boost the stock price in the near term while investing far more in a short (non-public) position. Thus their net position is actually a bet against the company but their public position looks favorable. Activist investors often engage in public campaigns to influence stock prices. Additional transparency in this area would help investors by providing insight into the incentives of the hedge funds and the messages they are promoting about a company's prospects.

The Brokaw Act addresses three major gaps in the current legal framework related to the requirements that investors disclose when they accrue large ownership positions in a public company. First, it shortens the 10-day window between crossing the 5% ownership threshold and the required 13-D filing -- the period when trading activity spikes -- down to 2 days. Second, it reforms the definition of "groups" under section 13(d) so that so-called wolf packs, groups of short term investors seeking cash payouts, can trigger the collective ownership threshold collectively. Finally, the bill extends section 13(d) to require disclosure of "net short" positions, that is, investors would have to disclose their full position, preventing them from profiting off a large hidden short position while taking a public long position to boost the stock price.

The reforms proposed in the Brokaw Act are common sense changes to address each of these problems. They adapt the existing securities laws to cover current practices and are essential for the strength of our markets and capital formation.

#### **S. 2499—Compensation for Cheated Investors Act**

One of the central flaws in our current system of securities regulation is the weak and inconsistent nature of the regulation of individuals and firms that provide investment advice. As an economic matter, broker-dealers, insurance agents, and investment advisors all provide investment advice. There should be a single standard of fiduciary duty that blocks self-interested behavior by all three types of advisors, and this duty should be heightened when retirement assets or other ERISA assets are at stake. But in our current system, there are significant differences in how these three types of advice providers are regulated, and how the regulations are enforced.

One particularly egregious problem that has resulted from this system is that when duties to investors are enforced by regulators, defendants are able to avoid paying damage awards, and are able to move among the three types of advice provider without consequence. Consumer protections mean nothing if regulators are unable to guarantee that defrauded consumers are made whole.

In the case of broker-dealer misconduct, a disturbing number of damage awards to investors by regulators and the courts never reach the harmed investors. The Financial Industry Regulatory Authority's (FINRA) Dispute Resolution Task Force found that in 2013 more than \$62 million in arbitration awards to consumers went unpaid, with a large number of unpaid awards assessed against broker-dealers who had become inactive since the complaint was issued.<sup>4</sup> Between 2012 and 2016 unpaid FINRA arbitration awards totaled nearly \$200 million.<sup>5</sup>

The compensation for Cheated Investors Act would make sure investors defrauded by brokers are able to collect the full amount of the award owed them while increasing accountability and public trust in the financial system and broker-dealers.

This bill would require FINRA to establish a compensation fund for defrauded investors who have not been able to collect from brokers even after winning arbitration or court judgment. The fund would be

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<sup>4</sup> FINRA Dispute Resolution Task Force, Final Report and Recommendations of the FINRA Dispute Resolution Task Force, 50 (2015), available at <https://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf>.

<sup>5</sup> FINRA, Discussion Paper--FINRA Perspectives on Customer Recovery, 7 (Feb. 8, 2018), available at file:///C:/Users/slewis/Downloads/finra\_perspectives\_on\_customer\_recovery.pdf.

supported by fines and penalties charged to FINRA-regulated broker-dealers. Greater transparency for consumers is also incorporated into the bill in the form of an annual report to be published by FINRA detailing the number and value of arbitrations, awards, and unpaid claims. FINRA already collects this data and shares it with other regulators. Sharing it with the public will help improve confidence in the financial system without significant costs to regulators, broker-dealers, or investors.

FINRA has acknowledged the problem of unpaid awards and a recent discussion paper from FINRA staff included such an approach in their list of potential measures to address unpaid claims.<sup>6</sup> This bill gives FINRA substantial latitude in administering its basic mandate, and we believe FINRA should work with the bill's sponsors to ensure that if the bill passed that its implementation was maximally effective both from the perspective of seeing to it that awards were paid and from the perspective of FINRA's effectiveness as a self-regulatory body.

Ensuring that awards are actually paid is a basic test of FINRA as a self-regulatory body. This bill is the consequence of FINRA failing to pass that test. But in reality what S. 2499 really does is give FINRA another chance to get it right, while at the same time making clear that FINRA cannot continue to ignore the problem. Passing S.2499 is in the interests of investors and in the interest of maintaining and improving the integrity of our securities laws.

### **S 536 -- Cybersecurity Disclosure Act of 2017**

The need for the board and upper management responsibility for corporate cybersecurity is, by now, an accepted part of running a business. Data breaches have cost consumers and investors millions in recent years.

This bill directs the SEC to mandate issuer disclosure of whether any board members have expertise or experience in cybersecurity and to detail that expertise/experience; if no board member has cyber expertise, the company must disclose how cybersecurity factors were taken into account in selecting board members.

At a time when cybersecurity compromises can cause significant financial and reputational damage to businesses, investors have a reasonable expectation that publicly traded companies invest in protecting employees' and consumers' data as well as proprietary business information and internal communications. But as matters stand today investors have no real way to be sure companies are actually doing any of these things. This bill requires the SEC to promulgate rules that require companies to be transparent about what they are doing, and to do so within the context of the securities laws where misrepresenting what they are doing would subject officers and directors to liability.

Again, like the issue of FINRA not ensuring awards are paid, this is an issue that the Commission should long ago have addressed through rulemaking. But in the absence of Commission action around the issue of cybersecurity at the board level, S. 536 creates a workable framework for ensuring investors are properly informed about the seriousness with which their companies are taking these risks.

### **S. 2953— Expanding Access to Capital for Rural Job Creators Act**

S. 2953 amends the list of entities the SEC Advocate for Small Business Capital Formation considers in its duties. The first change mandates the Advocate "identify problems that small businesses have with securing access to capital, including any unique challenges to minority-owned small businesses, women-owned small businesses, and small businesses affected by hurricanes or other natural disasters." The second change requires the Advocate report annually "a summary of the most serious issues encountered by small businesses and small business investors, including any unique issues encountered by minority-

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<sup>6</sup> FINRA, Discussion Paper--FINRA Perspectives on Customer Recovery (Feb. 8, 2018), available at [https://www.finra.org/sites/default/files/finra\\_perspectives\\_on\\_customer\\_recovery.pdf](https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf).

owned small businesses, women-owned small businesses, and small businesses affected by hurricanes or other natural disasters and their investors, during the reporting period.”

These changes are sensible ones in light of the challenges faced by minority, women-owned and rural small businesses, and the extraordinary challenges faced by small business owners in many parts of this country as a result of natural disasters and the growing costs of climate change.

We note however that for this mandate to actually be helpful to small business requires that the SEC Advocate effectively distinguish between the interests of actual small businesses and the interests of large firms, which are increasingly dominant in the U.S. economy and in the U.S. capital markets. This is an area that deserves more thoughtful and sustained oversight by this Committee.

With that important reservation we support S. 2953.

### **8-K Trading Gap Act of 2018 (Van Hollen)**

This bill addresses another problem involving inside information. Similar to the gaps in securities laws addressed by the Brokaw Act, this bill seeks to expand the language of current legislation to cover actions clearly prohibited by the spirit and intent of the legislation.

In this case, there is a 4-day gap between when an issuer determines that it is in possession of material non-public information and when it must file Form 8-k making that information public. This gap provides opportunities for insiders to trade on that information - evading the clear intent of the law.

This practice was confirmed by a research report published by a group of Harvard and Columbia professors in 2015 that coined the term, the “8-k Trading Gap”. It looked at a dataset of over 15,000 Form 8-ks and tracked insiders’ trading transactions within the window before the disclosure was filed. Unsurprisingly, it found that insiders could almost always anticipate the direction of any price movement following an 8-k announcement. Additionally, they found “systematic abnormal returns of 42 basis points on average, per trade, from trades by insiders during the 8-K gap.” And further, if insiders engaged in an open-market purchase of their own company’s stock, they earned even larger abnormal returns of 163 basis points, which is of course far higher on an annualized basis.<sup>7</sup>

This bill directs the SEC to issue rules to restrict officers and directors from profiting by trading on inside information during the 8-k trading gap. Again, this is a common sense reform that merely extends the current legal framework to cover current abuses.

### **Conclusion**

The AFL-CIO commends the Committee for holding this hearing that in every respect addresses serious issues in capital markets regulation. Investors will benefit if loopholes can be closed that encourage self dealing and insider trading. Investors will also benefit from legislation that encourages regulatory bodies as diverse as FINRA and the Office of the Small Business Advocate at the SEC to be more effective in doing their jobs. However, we strongly oppose the two bills in front of you, H.R. 4015 and S. 2756, that propose to weaken investor protections and the ability of our corporate governance system to perform its function of encouraging the managements of public companies to act in the long term best interest of the corporations and their shareholders that they serve.

Thank you again for the opportunity to testify today and I welcome your questions.

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<sup>7</sup> Cohen, Alma and Jackson, Robert J. and Mitts, Joshua, The 8-K Trading Gap (September 7, 2015). Columbia Law and Economics Working Paper No. 524. Available at SSRN: <https://ssrn.com/abstract=2657877> or <http://dx.doi.org/10.2139/ssrn.2657877>.