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TESTIMONY

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Subcommittee on Economic Policy, hearing entitled
"Short-termism in Financial Markets"

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Chairman Brown, Ranking Member DeMint, and distinguished members of the Committee, it is a privilege to testify in this forum today. My name is J.W. Verret. I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

My research is concerned with corporate governance and examining the incentives that guide corporate decision-making. 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 Committee 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 use the phrase "long-term investing" as a cover for what are in reality purely political goals.

There are two key drivers of short-termism that I will discuss today: politically-motivated pressure from Institutional Investors; and quarterly earnings predictions.

One cause of short-termism is the federal securities laws, which encourage Wall Street's quarterly earnings fixation. This is an example of the unintended consequences of regulation, as the quarterly reporting requirements of the Securities laws actually make the problem worse. Analysts predict quarterly earnings, and companies feel pressure to meet those predictions.

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 insistence on environmental or health policy reforms at companies they target.

In this instance, laws that provide shareholders greater involvement in corporate decision-making facilitate short-termism. Public Pension Funds run by state elected officials and Union Pension Funds are among the most vocal proponents of shareholder powers. Provisions in Title IX of the Financial Regulation bill currently being debated on the Senate floor actually stand to 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 a trillion dollars. This could cause pension funds to fail to meet their obligations for retirement funding, cost of living increases, and retiree health care for teachers, firefights, policemen and other government workers. The most concerning conflict of interest occurs when these special interests cater to voters or to current union workers at the expense of pensioners and retirees.

Government leaders and business leaders are held accountable by entirely different means. Government leaders are held accountable by their ability to get votes. Business leaders are held accountable by their ability to obtain profits for shareholders. And the overwhelming majority of those 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 “long term investing” as a smokescreen 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 labor union. 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 decision in the area losing business, and especially to a union whose workers may lose their jobs. However those costs can also be more than made up for with increased returns to pension investors in the private equity fund, lower costs for consumers, new business opened in other jurisdictions, and the security of the pensioner’s income.   I thank you for the opportunity to testify, and I look forward to answering your questions.