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Office of Commissioner
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Prepared Remarks[*] of
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Thank you all for attending the FTC's Hearings on Consumer Protection and Competition as we assess how the agency can be more effective in tackling today's problems in the economy.

Today, large corporations increasingly dominate the economy. In the past twenty-five years, the total revenues of Fortune 500 firms have substantially increased their share of GDP, and the Fortune 100 firms have grown their share even faster.[1] These corporations are complex, sprawling organizations with significant power to exert over the economy and democracy. Compared to Main Street businesses, these firms are more integrated with Wall Street and global financial markets. In my view, these companies frequently do not make decisions in ways that our economics textbooks predict.

I want to discuss how Wall Street incentives and corporate governance concerns can distort firm behavior. The FTC should not and cannot ignore these incentives, since they may be the root cause of decisions that break the law.

Originally, corporations were specifically chartered by state legislatures to help facilitate capital raising and activities that would benefit the public. Unlike charters in Britain that were bestowed by the Crown, states sought to ensure that corporations acted like mini-republics by outlining how elections for directors would take place with the hope that board members would balance interests among shareholders.[2] But that original vision has faded.

In today's hearing, many of you have been focusing on the implications on a specific market trend: the increasing dominance of passive equity index funds. But there are other corporate

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[*] The views expressed below are my own and do not necessarily reflect those of the Commission or of any other Commissioner.
[1] Andrew Flowers, *Big Business Is Getting Bigger*, FIVETHIRTYEIGHT (May 18, 2015), *available at* https://fivethirtyeight.com/features/big-business-is-getting-bigger/.
[2] Justin Fox, *What the Founding Fathers Really Thought about Corporations*, HARVARD BUSINESS REV. (Apr. 1, 2010), *available at* https://hbr.org/2010/04/what-the-founding-fathers-real.html.

governance trends that we need to be thinking about. I want to briefly discuss two of these: the explosion of corporate debt and the distorted incentives in executive compensation packages.

First, despite earning record levels of profits, the U.S. corporate sector is deeply in debt. From 2007 to 2017, outstanding bonds for nonfinancial corporations in the United States more than doubled from $2.3 trillion to $4.8 trillion.[3] Overall, American companies now owe more than $9 trillion in debt. The ratio of cash-on-hand to debt has fallen to one of its lowest points ever.[4]

A decade ago, the economy unraveled and highly leveraged Wall Street banks and homeowners with toxic mortgages were at the center of the storm. While debt levels have since gone down for both banks and households, debt for nonfinancial corporations has surged. At the time of the crisis, we heard a *lot* about families who were irresponsible for taking on so much debt, but we didn't hear so much about all of the big companies who did exactly the same thing.

Don't get me wrong. Debt can be useful. Debt can help a shop buy inventory or a manufacturer open up a plant to meet demand. This kind of debt makes economic sense because the investment has real-world cash flows to service that debt. But sometimes debt is issued for other purposes that are disconnected from real investment. Playing tax games, buying back stock, or snapping up a competitor who might pose a threat are just a few of these examples. That's where enforcers need to be more wary.

But there's other cause for concern with heavy debt loads. When companies borrow too much, they take on more risk. Heavily indebted companies can get desperate and will go to great lengths to keep creditors happy, since those lenders control their fate. And that's a situation ripe for illegal behavior. A company in dire straits would have more incentive to save money by taking illegal shortcuts or make money by blocking competitors using illegal practices.

One firm that I've closely studied and investigated is ITT Educational Services, a very large, publicly traded for-profit college chain that is now defunct. The company started off as trade schools preparing students for jobs in demand. But as it became hungry to attract interest from Wall Street investors, it took on more debt and engaged in riskier practices. Due to its own financial position, investing in creating high-quality programs would have put the company in peril. So to stay afloat, the company aggressively signed up students for tens of thousands of dollars in loans to enroll in programs of questionable value. By doubling down on the debt-driven deception, it destroyed the lives of so many students and their families, who have been crushed by financial ruin. Law enforcement eventually took action. The Consumer Financial Protection Bureau,[5] the Securities & Exchange Commission,[6] and others sued ITT. The

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[3] Susan Lund et al., *Rising Corporate Debt: Peril or Promise?*, MCKINSEY & CO. (June 2018), *available at* https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/rising-corporate-debt-peril-or-promise.

[4] Jeff Cox, *A $9 Trillion Corporate Debt Bomb Is 'Bubbling' in the US Economy*, CNBC (Nov. 21, 2018), *available at* https://www.cnbc.com/2018/11/21/theres-a-9-trillion-corporate-debt-bomb-bubbling-in-the-us-economy.html.

[5] Press Release, Consumer Fin. Prot. Bureau, *CFPB Sues For-Profit College Chain ITT for Predatory Lending* (Feb. 26, 2014), https://www.consumerfinance.gov/about-us/newsroom/cfpb-sues-for-profit-college-chain-itt-for-predatory-lending/.

[6] Press Release, Securities and Exchange Comm'n, *SEC Announces Fraud Charges against ITT Educational Services* (May 12, 2015), https://www.sec.gov/news/pressrelease/2015-86.html.

Department of Education sanctioned the company for financial mismanagement.[7] But for the students defrauded by the company, it was too late for any legal action or settlement to fix the damage that was done.

In the merger context, heavy debt loads can also cause trouble. A common way that antitrust enforcers solve the anticompetitive concerns in a deal is to require divestitures. Parties will tell a great story about how a divestiture buyer will become a hard-charging player that will innovate or push down prices. But when the new competitor is loaded up with debt, it can make it much harder – or even impossible – to compete.

In one matter involving discount dollar stores, a private equity group purchased several hundred stores that were required to be divested as part of a merger.[8] But instead of proving to be an upstart challenger, the private equity fund buyer ended up selling them to another large industry competitor after telling the FTC it could no longer operate as a "viable standalone business."[9] In these deals, that debt doesn't stick with the private equity buyer. It typically remains a burden on the business, until the debt is paid or until the business dissolves, raising even more questions about when competition will be restored.

In a matter that came before the Commission recently, two massive industrial gas corporations, Praxair and Linde, sought to merge to become even bigger, raising a host of anticompetitive concerns.[10] While these may not be household names, industrial gases are the inputs to an extremely wide range of goods produced in our economy. Due to some nuances with this deal, the FTC was in an unusual position to negotiate a remedy or to block the merger outright. To address certain overlaps, the parties sought to divest certain assets.

I expressed concerns about the divestiture buyer's debt level and whether this would jeopardize their ability to grow and compete vigorously.[11] The whole reason to divest assets is to create a meaningful competitor in a market where a merger puts competition in jeopardy. But that hope for competition will not exist for very long – or at all – if the would-be competitor goes bankrupt or runs the divested assets into the ground by selling off their most valuable pieces to service their debt. Despite our unique position, the Commission chose not to safeguard against these

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[7] Danielle Douglas-Gabriel, *This Really Might Be the End of ITT*, THE WASH. POST (Aug. 25, 2016), *available at* https://www.washingtonpost.com/news/grade-point/wp/2016/08/25/this-really-might-be-the-end-of-itt/.

[8] Press Release, Fed. Trade Comm'n, *FTC Requires Dollar Tree and Family Dollar to Divest 330 Stores as Condition of Merger* (July 2, 2015), https://www.ftc.gov/news-events/press-releases/2015/07/ftc-requires-dollar-tree-family-dollar-divest-330-stores.

[9] Press Release, Fed. Trade Comm'n, *FTC Approves Sycamore Partners II, L.P. Application to Sell 323 Family Dollar Stores to Dollar General* (Apr. 27, 2017), https://www.ftc.gov/news-events/press-releases/2017/04/ftc-approves-sycamore-partners-ii-lp-application-sell-323-family. *See also* Diane Bartz, *Dollar Express Sues Dollar Tree for Driving It out of Business*, REUTERS (June 2, 2017), *available at* https://www.reuters.com/article/us-Dollar-Tree-lawsuit-dollarexpress-idUskbn18t30z.

[10] Press Release, Fed. Trade Comm'n, *FTC Requires International Industrial Gas Suppliers Praxair, Inc. and Linde AG to Divest Assets in Nine Industrial Gas Markets as a Condition of Merger* (Oct. 22, 2018), https://www.ftc.gov/news-events/press-releases/2018/10/ftc-requires-international-industrial-gas-suppliers-praxair-inc.

[11] Statement of Commissioner Rohit Chopra, In the Matter of Linde AG, Praxair, Inc., and Linde PLC, Commission File No. 1710068, Oct. 22, 2018, *available at*: https://www.ftc.gov/public-statements/2018/10/statement-commissioner-chopra-matter-linde-ag-praxair-inc-linde-plc.

risks. While I hope my concerns do not materialize, the significant chance that they could says to me that we need a new approach to evaluating the financial condition of a divestiture buyer.

We could start by taking a page from the business playbook. Sophisticated lenders go to great lengths to protect themselves when extending credit. They include provisions that require corporate borrowers to keep enough cash on hand, accelerate repayment when a firm is sanctioned by regulators, or even forbid questionable payouts to investors and management. And when things go wrong, these lenders make sure they get paid back way before any government fine comes due.

If Wall Street creditors can protect themselves from getting burned in these situations, enforcers should consider using similar provisions to protect the public. And if those provisions aren't possible, I would argue that we are better off seeking to block a deal than allowing one through that includes divesting to a high-risk buyer.

Second, excessive executive compensation is a virus in the economy that is distorting incentives. Consumer protection and competition regulators and enforcers cannot ignore this. CEO pay in particular has risen dramatically. Many might believe that CEOs are increasingly more important to corporate performance than an average worker. But are top executives in many industries really ten times on an inflation-adjusted basis more valuable than their predecessors from a generation ago?[12] Many long-term shareholders are saying no.

As many of you know, in 1993, Congress and President Clinton sought to cap the deductibility of executive pay at $1 million. But when it was enacted, the law had a big exception for "performance-based" pay. This policy change created more momentum for compensating executives with stock options and stock grants. With stock options, executives are paid for any gains the company's stock makes over a certain price for a particular period of time. With stock grants, executives receive actual shares of the company, but they are required to hold on to them for a certain amount of time. These compensation vehicles are intended to align the interest of executives with those of long-term shareholders.

But according to some evidence, these performance-based incentives may actually lead to unnecessary risk-taking and even lawbreaking. Stock options, in particular, have no value unless a stock price exceeds the strike price at which the option can be exercised. In other words, if there is no stock appreciation before the expiration date, it's worthless. This can lead to executives taking risks by operating on the margins of the law to create short-term gains that make options valuable. According to a 2016 paper, a stock option-heavy executive compensation package drastically increased the likelihood of a corporation breaking environmental laws or engaging in financial misconduct.[13]

[12] John Cassidy, *Paul Volcker's Wisdom for America's Rigged Economy*, THE NEW YORKER (Nov. 26, 2018), *available at* https://www.newyorker.com/news/our-columnists/paul-volckers-wisdom-for-americas-rigged-economy.
[13] Dylan Minor, *Executive Compensation and Environmental Harm* (Harvard Business School Working Paper No. 16-076, 2016), http://www.hbs.edu/faculty/Publication%20Files/16-076_ee60daf1-88cb-4959-bb3d-847674322da0.pdf.

But even stock grants come with risks for executives reluctant to see their net worth decline. Take the pharmaceutical industry. Executives with stock grants may not see big short-term payoffs from doing what they are supposed to be doing: curing disease by making life-saving drugs. Inventing new drugs takes time and money – that's why the public grants them patents and exclusivity periods that can often result in a monopoly. But many executives do not want to fully embrace capitalism by competing; they want to preserve their company's stock price and their personal wealth. So, instead, they focus energy on blocking generic competition to drugs that have long been on the market.

Indeed, by shifting the focus from making medicine to making themselves rich, I worry that these executives are turning pharma companies into patent trolls. Filing frivolous patents, making minor or cosmetic modifications to drugs, and playing various other patent games allows them to keep raking in government-granted monopoly profits. The longer they can maintain their monopoly patent, sometimes through breaking the antitrust laws, the lower the chances these executives will see their company stock price and personal net worth decline. But even if their company is caught, it might be too late as they might have already cashed out.

The decision to cheat consumers, rig the market, or otherwise break the law can provide big payouts to executives, but when it comes to paying fines, the ones who call the shots almost never face accountability. Executives tell shareholders that this is the cost of doing business. It is critical we understand that executive compensation incentives might drive misconduct, and when a defendant is keen on settling, we may need to address those distorted incentives directly.

There have been instances where enforcers have required significant changes to executive compensation policies. For example, in the civil and criminal settlements with GlaxoSmithKline[14] and Johnson & Johnson,[15] the corporations were required to amend their policies to ensure adequate clawbacks from executives when lawbreaking occurred.

The role of heavy debt and executive compensation in both consumer protection and competition matters raises many questions about our approach to settlement remedies. When we find that heavy corporate debt poses risk, how should we safeguard against it? Should enforcers, like creditors, seek bans on stock buybacks and dividend payouts until debt levels and risk levels get under control? Should enforcers require recapitalizations, including raising equity capital, when companies claim they cannot afford to make victims whole? Should we require the company to sell off assets when they have too much debt to afford to pay back victims? Should we require clawback provisions to stop executives from getting a windfall when consumers are cheated? Should we seek compensation arrangements where executives guarantee payments to victims if their company goes belly up? Should we require more attestations, signed by executives or board members, that they have no personal knowledge of ongoing wrongdoing?

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[14] Press Release, U.S. Dep't of Justice, *GlaxoSmithKline to Plead Guilty and Pay $3 Billion to Resolve Fraud Allegations and Failure to Report Safety Data* (July 2, 2012), https://www.justice.gov/opa/pr/glaxosmithkline-plead-guilty-and-pay-3-billion-resolve-fraud-allegations-and-failure-report.

[15] Press Release, U.S. Dep't of Justice, *Johnson & Johnson to Pay More Than $2.2 Billion to Resolve Criminal and Civil Investigations* (Nov. 4, 2013), https://www.justice.gov/opa/pr/johnson-johnson-pay-more-22-billion-resolve-criminal-and-civil-investigations.

These are just some of the many other questions that we need to be asking about corporate governance remedies if we want to be taken seriously by bad actors in the boardroom.

Thank you for taking part in our examination of our approach to consumer protection and competition with today's focus on capital markets and corporate governance. While we are just scratching the surface, this must be the start of changing our approach to face the realities of an economy dominated by large firms.