UNITED STATES SENATE
COMMITTEE ON HEALTH, EDUCATION, LABOR AND PENSIONS

HEARING ON

PROTECTING AMERICA'S PENSION PLANS FROM FRAUD: WILL YOUR SAVINGS RETIRE BEFORE YOU DO?

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Testimony Of

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Chairman Enzi, Ranking Member Kennedy, and Members of the Committee:

I am pleased and honored to again appear before this distinguished, storied Committee. I welcome this opportunity to discuss protecting employee pension plans from fraud, and applaud you for having the discussion.

Overview

I bring to your discussion the perspective of an experienced employee benefits law practitioner who has represented pension plans as well as plan participants and plan sponsors for more than 25 years. I have had the honor of serving two, three-year terms on the ERISA Advisory Council of the Labor Department, most recently as Chair for 2002, in both Republican and Democratic Administrations. I have also held several positions with the American Bar Association, including Chair of its Joint Employee Benefits Committee and as a member of the governing Council of the Section on Labor and Employment Law. I am a Charter Fellow in the College of Labor and Employment Lawyers as well as a Charter Fellow of the American College of Employee Benefits Counsel, both of which are peer-elected honorary organizations. Of course, I am not speaking on behalf of any of these organizations.

My focus in this discussion is on the relationship between pension plans and the investment services industries. That relationship is a dangerous intersection between the ethics of the marketplace and fiduciary duty to plan participants. The United States Supreme Court has made the following observation about that intersection:

> "Many forms of conduct permissible in a workaday world of those acting at arms-length are forbidden to those bound by fiduciary ties. A [fiduciary] is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior [for fiduciaries]." *Pegram v. Herdrich*, 530 U.S. 211, 224-25 (2000).

Unfortunately, the opportunities to make enormous profits and the competition for those opportunities have led too many in the investment services community to abuse their fiduciary duties to pension plans and other investors, and to entice other plan fiduciaries to violate their duties. To often the morals of the marketplace are that the risk of being caught wrongdoing is an acceptable business risk, and the restitution or penalty imposed if caught is a manageable cost of doing business. The words "everybody does it" are to often uttered in defense of wrongdoing. There is a certain arrogance that comes with the investment community's strong influence over the Nation's economy.

The recent spate of investment community scandals, many involving frauds on pension fund investors, suggests that the lessons of earlier scandals have not been learned. And, signals from the Securities and Exchange Commission (SEC), the Federal Reserve, and media reports indicate that more scandals can be expected,

particularly among hedge funds, as pension funds and other institutional investors search for higher investment returns than traditional investments in equities and fixed income securities are expected to produce in the foreseeable future.

The Capital Consultants fraud is but one illustration of a broader problem of the investment community placing business interests ahead of fiduciary duty.

There needs to be a change in the culture of the investment community concerning dealings with employee pension plans. And, that cultural change seems possible only if there is greater regulatory oversight of investment services providers by the SEC. In this world of an ever-increasing variety and complexity of investment vehicles, only government has the resources and authority deter and detect sophisticated fraud; pension funds do not.

Will the SEC meet this challenge? Will Congress have the political will to allow the SEC to meet this challenge?

Pension Plans Depend On Investment Community

Employee pension plans collectively constitute one of the largest pools of domestic investment capital, especially if you include “401(k) plans” as pension plans. Pension plan investments are valued in the trillions of dollars. Naturally, they receive a lot of attention from the investment services industry, including investment managers, investment consultants, brokers, banks, insurance companies, mutual funds, hedge funds, other collective investment funds, and lots of other organizations and individuals. Pension plans are a gold mine of investment fees.

Pension plans depend on the investment services community. The typical pension plan engages a collection of investment professionals to perform services related to the plan’s investments. Private sector plans are, as a practical matter, compelled to do so by the Employee Retirement Income Security Act (ERISA). ERISA’s fiduciary standards of conduct require, among many other things, that a plan’s investment program be prudent in structure and operation. Prudence is really a process standard; whether an investment decision is prudent is measured by the soundness of the decisionmaking process, not by the future success or failure of the decision. Prudent investment decisionmaking generally requires specialized knowledge and expertise that few laymen possess. Indeed, many newly developed investment vehicles and financial instruments have become so complex that few professionals, and even fewer regulators, understand them.

An investment consultant (or consultants) is engaged: to develop and monitor the plan’s asset allocation; to develop and monitor investment guidelines and policies; to recommend investment managers and investment vehicles; and to monitor the performance of the investment managers and investment vehicles. Generally the investment consultant is an advisor to the plan’s governing fiduciary (*e.g.* board of

trustees in a multiemployer plan setting, corporate officers in a single employer plan setting). Nonetheless, the consultant is a fiduciary within the meaning of ERISA because the consultant is giving investment advice for a fee. In performing its services for the plan, the consultant is subject to ERISA's fiduciary standards of conduct and prohibited transactions rules.

An investment management firm (investment manager) generally is engaged to assume discretionary, fiduciary responsibility to manage a specified portion of the pension plan's investment portfolio (*e.g.* large cap equity, small cap equity, fixed income or balanced account). The investment manager decides which specific investments to make, hold and sell (*e.g.* buy or sell a particular company's stock or a particular corporate bond). Typically, a plan engages more than one investment manager, each with fiduciary responsibility for a portion of the plan's portfolio, reflecting the plan's asset allocation decisions and the need for investment diversification. Each investment manager is an ERISA fiduciary with respect to the plan because it has discretionary authority regarding the management of plan assets.

ERISA strongly encourages the engagement of investment managers beyond the need for prudent investment decisionmaking. If a pension plan's governing fiduciaries engage an investment manager, ERISA generally shields the governing fiduciaries from liability for the investment manager's investment decisions. For this statutory shield to apply, the investment manager must be registered with the SEC or a similar State agency, unless it is a regulated bank or insurance company. The investment manager must also acknowledge in writing that it is a fiduciary with respect to the pension plan under ERISA.

The governing fiduciaries continue to have a fiduciary obligation to monitor the performance of the investment manager relative to the pension plan's investment policies and guidelines as well as relative to some established benchmarks, and decide whether to retain or discharge the investment manager. This monitoring function, however, is generally assigned to the investment consultant who advises the plan's governing fiduciaries.

Investment brokers are engaged by the pension plan's investment managers to execute the manager's decisions to buy and sell particular securities for the plan's portfolio. The investment manager generally selects the broker for each transaction and agrees to pay the broker a commission for its trading services. The commission is paid to the broker using the pension plan's assets, not the manager's own assets. Often, a portion of the commission, or its value, is rebated to the investment manager by the broker under so-called "soft dollar" arrangements. The investment manager personally benefits from these soft dollar rebates by, at a minimum, reducing its own business overhead costs. To some extent, SEC rules allow investment managers to maintain soft dollar arrangements with brokers, despite their questionable status under ERISA. (More about this later.) Some pension plans try to preempt such soft dollar arrangements by participating in so-called commission recapture programs under which

one or more brokerage firms agree to rebate a portion of the commissions to the plan, rather than to the plan's investment managers.

Increasingly, pension plans are investing (buying units or shares) in pooled investment vehicles managed by investment managers, rather than engaging the investment manager to manage a separate portfolio for the plan. Some investment managers are encouraging this shift, asserting that pooled arrangements are most cost efficient (although I suspect that the managers have their own motives as well).

For the governing fiduciaries of the plan, a decision to buy units in a pooled investment fund presents a fundamentally different decision than a decision to hire an investment manager to manage a separate portfolio, viewed from ERISA's perspective. The governing fiduciaries are the decisionmakers on the question of whether to invest in the pooled fund; that is, whether to buy units in the fund. Once the investment is made, the manager of the pooled fund has fiduciary responsibility for the management of the fund's assets (including the money invested by the pension plan) in accordance with the investment fund's governing documents and applicable law. But, the decision to make the investment in the fund is the responsibility of the pension plan's governing fiduciaries, not the manager of the investment fund. (Managers of pooled investment funds typically include such a disclaimer in the investment documentation.) Well-advised pension plan governing fiduciaries will rely on a qualified investment consultant to conduct a prudent, due diligence review of the investment vehicle and to advise them on whether the investment is appropriate for the pension plan. Few governing fiduciaries of plans are qualified to make such an investment decision without professional advice.

The amount of fees that investment managers earn from pension plan investments is enormous. Generally management fees are based on a percentage of the market value of the portfolio or fund being managed. As the value of the portfolio or fund increases, the manager's fee automatically increases. The value of the portfolio may increase through investment growth or by the addition of investment capital (*e.g.* new investors). With each new pension plan client, an investment management firm typically gains an additional fee base (more assets to manage) without much additional work because the firm applies essentially the same strategies to all of its clients or to groups of clients.

In contrast to the investment managers and other investment professionals, the governing fiduciaries of pension plans are typically unpaid volunteers. In a multiemployer plan setting, the governing fiduciary is the board of trustees, consisting of labor and management representatives in accordance with the Labor Management Relations ("Taft-Hartley") Act. ERISA prohibits the pension plan from compensating these trustees for their services to the plan if they are (as is usual) full-time employees of the sponsoring union and of contributing employers. They can only be reimbursed for their actual and reasonable expenses incurred in performing services for the plan. In a single employer plan setting, the governing fiduciaries are typically employees of

the plan sponsor whose plan duties are part of their corporate duties.

In short, pension plans are at the mercy of the investment services community.

Investment Services Community Abuses and Corruption

Conflicts of interest, self-dealing and other abuses are no strangers to the investment services community. Indeed, there seems to be a continuing stream of major scandals in the community. Some recent examples:

* Mutual Fund Abuse Scandal (2003-04): Several large mutual funds were found to have permitted favored customers to engage in market-timing and late trading abuses to the detriment of other investors. In addition, the SEC found that a large percentage of brokerage firms were assisting the favored clients to engage in these abuses. Several financial institutions were required to make restitution and pay fines in the tens and hundreds of millions of dollars (*e.g*:, Bank of America-$675 million; Alliance Capital Management-$600 million; Massachusetts Financial Services-$350 million; Canary Capital Partners-$40 million). The SEC belatedly took action to prevent these types of abuses. Notably, in a March 2004 report, the SEC admitted that its review of mutual fund records "did not reveal the covert arrangements that fund executives had with select shareholders" prior to the abuses becoming public.

* Mutual Fund Overcharges (2003): The SEC and NASD found that more than 400 securities firms had overcharged investors for sales charges on mutual fund investments by $86 million in 2001 and 2002.

* Self-Dealing Investment Research (2002-03): Merrill Lynch agreed to pay $100 million fine and take other actions in response to New York Attorney General's complaint that the Merrill Lynch analysts were recommending questionable stocks to investors in the hope of gaining the investment banking business of the companies whose stock they were falsely promoting. Nine other "Wall Street" investment firms entered into a private litigation settlement under which they collectively agreed to pay $1.4 billion.

* Insurance Broker Fraud (2005): Marsh & McLennan Companies, the Nation's largest insurance broker, agreed to pay $850 million in restitution to settle charges by the New York Attorney General that it steered its brokerage clients to insurance companies that paid kickbacks to Marsh & McLennan, and that it staged phony bidding among insurance companies to conceal the "pay to play" kickback scheme from clients. Even more recently, AON, the second largest insurance broker, agreed to pay $190 million to settle the same charges. Other insurance brokerage firms have

been implicated as well.

Not so long ago hedge fund manager Long-Term Capital Management had to be saved from collapse with a $3.6 billion bailout, that investment firms were peddling inappropriate derivative investments and junk bonds to pension plans.

Today, as pension plans and other institutional investors search for higher returns in the face of predictions of low returns in traditional equity and fixed income portfolios, the investment community is developing and marketing even more complex and exotic investment vehicles that are supposed to outperform traditional investments. Some of these vehicles are so complex and multilayered that they are not well-understood by professionals and regulators, much less laymen.

Hedge funds are being aggressively marketed to pension plans as the clear path to higher returns. The extraordinary management fees charged by hedge funds (typically 2% of assets plus 20% of capital gains and appreciation) have made hedge fund managers wealthy beyond imagination. Yet, dire predictions are being made that the hedge fund industry will produce the next major scandal. The SEC has reported "an increasing incidence of fraud" among hedge funds; 51 cases of hedge fund theft, fraud and abuse caused a loss of more than $1 billion to investors. In its 2003 report on hedge fund growth, the SEC stated: "The Commission's inability to examine hedge fund advisers has the direct effect of putting the Commission in a 'wait and see' posture vis-a-vis fraud and other misconduct." Federal Reserve Chairman Greenspan opined earlier this week that many hedge funds are pursuing high risk and complex trading strategies that could result in significant losses.

Yet, the SEC's recent action to require the vast majority of hedge funds to register with the SEC for the first time in 2006 was greeted with condemnation in the investment community. Indeed, the SEC vote on the new requirement was 3-2. In commenting on this controversy in a May 12, 2005 speech, outgoing SEC Chairman Donaldson made the following observations about the difficulty of expanding regulatory oversight of the investment community, and the difficulty of deterring and detecting fraud:

> "There is a certain mindset that holds that significant regulatory action is appropriate only in retrospect, or only after things have gotten so bad that the risk of investor harm threatens to become a certainty. We have sought to launch the Commission on a different course, an approach that anticipates problems before they develop, and deals with areas of concern that have perhaps lingered unattended for many years with their pernicious consequences long unnoticed by the public at large....
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> "The controversy generated by these reforms [i.e. hedge fund registration and market structure reforms] both within and without the Commission also illustrates the practical difficulties faced by the Commission when it seeks to take action

that is anticipatory in nature, as well as reactive....

"At the same time, there has been an increased number of enforcement actions involving hedge funds, and it was difficult to deter this fraud–or to discover it–without a compliance regime and a program of examinations and inspections by our staff...

"If history is any guide, it is just this sort of [competitive] pressure that can lead otherwise well-intentioned professionals to pursue practices that ultimately result in disaster for the investors that they serve."

Inherent Conflicts Of Interest Among Investment Firms

Conflicts of interest are inherent in some of the arrangements among investment community members that have some to be accepted practice ("everybody does it"). The most obvious of these practices is the so-called "soft dollar" arrangement. Most investment management firms have what are essentially kickback arrangements, called "soft dollar" arrangements, with the securities broker selected by the manager to execute trades for the investment manager's client pension plan. Under these arrangements, the investment manager pays a commission to the broker for the broker's services (using the pension plan's assets), and the broker rebates a portion of the commission to the investment manager in some form.

In other words, in addition to the investment management fee that the manager receives directly from the client pension plan, the manager receives a rebate of the plan-paid commission from the broker. This is big business inasmuch as pension plans, mutual funds and other institutional investors pay billions of dollars each year in brokerage commissions ($12.7 billion in 2002, half of which was rebated in the form of soft dollar goods and services according to the *Wall Street Journal*).

The Security Act and SEC rules allow investment managers to use soft dollar arrangements to obtain from brokers so-called "research" related products and services (*e.g.* securities research materials, software, Bloomberg terminals, magazine subscriptions); in essence allowing the use of commission rebates to offset what would normally be business overhead costs. This is called the Section 28(e) soft dollar safe harbor rule.

In a 1998 report on soft dollar practices, the SEC observed that soft dollars have been used to benefit the investment managers in ways that went well beyond the scope of "research." An SEC survey found that 35% of the brokers examined provided some clearly non-research goods, services and other things of value to investment managers, including office rent, office equipment and furnishings, employee compensation, and personal travel and entertainment. The SEC also found that the disclosure requirements for such arrangements were widely ignored.

While both the SEC and the Labor Department have recognized that soft dollar arrangements place a pension plan's investment manager in a conflict of interest, they have not been prohibited because Section 28(e) remains on the books. The SEC has a Task Force on Soft Dollars considering whether to narrow the scope of the "research" for which soft dollars can be used under 28(e) and whether to require more disclosure to pension plans and other investors about soft dollar arrangements.

From the ERISA perspective, soft dollar arrangements would be treated as prohibited transactions, essentially like kickbacks, but for ERISA's deference to other federal law, Section 28(e). So, the Labor Department has accept that managers may have soft dollar arrangements. However, according to Labor Department guidance, the plan's governing fiduciaries must monitor each investment manager's soft dollar arrangements to ensure that the manager is not being excessively compensated by the plan (considering both the investment management fee paid to the manager directly by the plan and the brokerage commissions rebated to the manager by the brokers). This is a mission impossible for most, if not all, pension plans. Pension plans do not have the resources or investigative authority of the SEC or the Labor Department.

Another example of conflicts of interest in the investment community are investment consultants that have arrangements with investment managers and investment funds to recommend the managers or funds to the consultants' clients in exchange for payments or other things of value to the consultant (so-called "pay to play" arrangements). Pension consultants' conflicts of interest was the subject of a May 2005 SEC staff report. It reports that it is commonplace for investment consulting firms to have arrangements with investment managers and investment funds that compromise the independence of the investment advice that the consultants give to pension plan clients about the investment managers and funds.

In a joint guidance statement issued on June 1, 2005, the Labor Department and the SEC placed responsibility for ferreting out consultants' conflicts of interest on the pension plans' governing fiduciaries. The statement is entitled: "Selecting and Monitoring Pension Consultants-Tips for Plan Fiduciaries." I've been asked by clients how the government can expect them to discover such consultant conflicts when it took the SEC so long to find them.

Capital Consultants Fraud

I understand that the Committee is particularly interested in the fraud perpetrated on various pension plans by Capital Consultants LLC in the 1990s, and that other witnesses have recounted the facts and circumstances of that matter to the Committee.

To me, the Capital Consultants matter is yet another example of how difficult it is to prevent and detect fraud by investment firms. In hindsight, it all seems so clear. But, at the time, Capital Consultants had the appearance of propriety: a large client base,

good performance figures, and some good references. Moreover, the collateral notes investment pool being marketed by Capital Consultants was a complex investment. Some of the pension plans' consultants blessed the plans' investment with Capital Consultants, although it is unclear how deeply they probed (or were capable of probing) into the complexities of the investment and the undisclosed arrangements among the players.

It was not until after Capital Consultants' collapse–with the benefit of aggressive and expensive private litigation and intervention by the SEC and Labor Department–that the corrupt machinations among Capital Consultants, Wilshire Financial, and various other firms and individuals were uncovered. Few, if any, pension plans have the wherewithal to engage in such an in-depth investigation of sophisticated conspiracies and complex financial instruments

Much has been made of the fact that Capital Consultants salesman Dean Kirkland provided free trips and other valuable gifts to some trustees of some pension plans, and that one trustee was paid substantial cash kickbacks. Needless to say, this conduct was improper in an ERISA context. Kirkland and a trustee who received the cash kickbacks were properly convicted of crimes under existing law. There is no lack of law prohibiting such misconduct, or governmental authority to investigate. Section 1954 of Title 18 of the United States Code, under which Kirkland was convicted, makes it a crime for service providers (and others) to offer or give a kickback to ERISA plan fiduciaries, and makes it a crime for any ERISA plan fiduciary to solicit or receive a kickback. In addition, ERISA itself treats such a kickback as a prohibited transaction that subjects the giver and the recipient to various civil remedies. And, in the context of labor-management relations, the Taft-Hartley Act (Section 302 of Title 29 of the United States Code) generally prohibits employer payments to union representatives.

The Labor Department's Employee Benefits Security Administration has broad authority (including subpoena powers) to investigate whether such a criminal or civil violation has occurred. In the context of multiemployer plans, the Labor Department's Inspector General also has criminal investigative authority.

The fact is that many in the investment community consider "travel and entertainment" for pension plan clients to be normal marketing; the kind of thing that "everybody does" because if they don't their competitors will. This is how business is conducted in the marketplace. I've heard some investment firm representatives say that their firms get upset if they don't spend their marketing budgets to get "face time" with clients. There seems to be little understanding among investment firms, or at least their representatives, that some marketing practices that might be "business as usual" are simply unlawful, even criminal, if used in the context of an ERISA-covered pension plan. This needs to change, but will only change if the investment firms realize that their business interests are better served by compliance with ERISA's restrictions on payments to or for plan fiduciaries. If investment firm representatives cease offering gifts and gratuities to plan fiduciaries, there will be nothing for plan fiduciaries to accept.

Conclusion

In sum, protecting pension plans from fraud requires a commitment to greater regulatory oversight of the investment services community. It is unrealistic to expect that pension plans can adequately protect themselves against sophisticated schemes involving complex financial transactions and secret conspiracies conceived and executed by smart people who are motivated by unmitigated greed. Only the SEC has the authority, expertise and other resources needed to deter and detect investment fraud. The question of the day is whether the SEC has the will and backing to more aggressively police the investment community.

Thank you again for this opportunity to participate in the Committee's discussion of this important issue. I would be pleased to answer your questions.