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CREATING GREATER TRANSPARENCY FOR PENSIONERS

HEARING

BEFORE THE

SUBCOMMITTEE ON HEALTH, EMPLOYMENT, LABOR AND PENSIONS

COMMITTEE ON EDUCATION AND LABOR

U.S. HOUSE OF REPRESENTATIVES

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CREATING GREATER TRANSPARENCY FOR PENSIONERS

Tuesday, July 20, 2010
U.S. House of Representatives
Subcommittee on Health, Employment, Labor and Pensions
Committee on Education and Labor
Washington, DC

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2175, Rayburn House Office Building, Hon. Robert Andrews [chairman of the subcommittee] presiding.

Present: Representatives Andrews, Wu, Kucinich, Fudge, Kildee, Holt, Courtney, Price, Kline, Guthrie, and McClintock.

Staff Present: Aaron Albright, Press Secretary; Tylease Alli, Hearing Clerk; Andra Belknap, Press Assistant; Jose Garza, Deputy General Counsel; David Hartzler, Systems Administrator; Ryan Holden, Senior Investigator; Sadie Marshall, Chief Clerk; Meredith Regine, Policy Associate, Labor; James Schroll, Junior Legislative Associate, Labor; Michele Varnhagen, Labor Policy Director; Matt Walker, Labor Counsel, Subcommittee on Health, Employment, Labor, and Pensions; Ed Gilroy, Minority Director of Workforce Policy; Ryan Kearney, Minority Legislative Assistant; Molly McLaughlin Salmi, Minority Deputy Director of Workforce Policy; Ken Serafin, Minority Workforce Policy Counsel; and Linda Stevens, Minority Chief Clerk/Assistant to the General Counsel.

Chairman ANDREWS. Welcome to the subcommittee hearing on the issue of transparency and accounting for what are frequently called alternative assets in defined benefit plans.

We are very happy to have an excellent panel. I want to thank my ranking member and friend, Dr. Price, for his cooperation and participation, and welcome the ladies and gentlemen of the public.

Noting that a quorum is present, the hearing of the committee will come to order.

Eighty-six million Americans depend on traditional defined benefit plans for their future income. As the great work of the Government Accountability Office has shown in 2008, led by Ms. Bovbjerg, who is with us this morning, the number of pension plans that are investing in hedge funds and private equity funds is growing rather precipitously. Upwards of about 91 percent, I believe the GAO study says, are involved in hedge funds, and a slightly smaller number in private equity. I may have that reversed, but it is a growing—it is 91 in private equity and, I think, 70 in hedge funds, or a number close to that.

And although one cannot be exact about the level of investment in those funds, it is certainly in the hundreds of billions of dollars. And, of course, similar choices are being made by individuals in defined contribution plans, as well.

I want to say emphatically from the beginning, I think the most important principle governing fiduciary decision-making in defined benefit plans is diversification of assets. I think that a prudent fiduciary is someone who understands well the diversification of risk and reward.

Given that principle, I am not in any way interested in any statutory or arbitrary limitation on investments in such assets for pension funds or anyone else. I don't think it is the job of elected officials to favor or disfavor any class of investments. I think we should be agnostic as to classes of investments. I think that we should write laws that impose high standards of fiduciary responsibility on those whose job it is to make those decisions. And I think we should then essentially get out of the way and let them exercise their fiduciary duty.

In order for people to exercise their fiduciary duty in a proper way, transparency is needed. In other words, one cannot really understand the potential risks and rewards of an investment if the data which underlie the dynamics of that investment are not easily and readily understandable.

In most cases, most classes of investments have a long history of regulatory disclosure and, frankly, have a measure of transparency that comes from the principle that, in a marketplace, people vote with their feet. So when one invests in a frequently traded public stock or public bond, market fluctuations, when one sees millions of shares traded or billions of transactions occur, will let one know what one's peers think about the value of an asset.

That kind of information is not readily available when it comes to alternative investments. They are typically thinly traded. In many cases, they are illiquid. In many cases, there may be no market at all that would help one determine what the marketplace thinks about the value of an asset.

Again, I emphatically believe that this phenomenon should not exclude these classes of assets from consideration by fiduciary trustees in defined benefit plans. I don't think that at all. But I certainly think that those fiduciaries ought to have ample information to real-time, relevant information so they can properly discharge their responsibilities as fiduciaries.

This, I believe, is not an ideological or political question; it is an empirical and analytical one. And the purpose of this morning's hearing is to assemble four individuals of great experience in this area and, I believe, great expertise in this area. And we welcome them to the subcommittee.

The questions we are interested in hearing about this morning are: What tools are presently available to pension plan fiduciaries in evaluating alternative investments? How complete or incomplete are these tools? How useful are these tools? What might supplement them and make them more useful?

What rules and standards govern those who prepare these tools? When one relies on an audited financial statement from a hedge fund or private equity fund to make a fiduciary decision, what

standards would govern the quality of that audited financial statement? What do we know about the competence and preparation of the preparer?

If there were conflicts of interest, what standards or rules would at least disclose or hopefully prohibit such a conflict of interest?

The purpose of this hearing is for those of us on the committee to get a sense of how those who are in the fiduciary world view the efficacy of the tools available to them and to evaluate whether, if at all, changes are necessary to public policy.

I want to say from the outset, I believe public policy does not necessarily mean statutes or regulations. It can come in the form of guidance from the Department of Labor. It could come in other less formal iterations.

But at the end of the day, here is what we are interested in achieving: We want to develop a body of knowledge that would give us a level of assurance that when fiduciaries are carrying out their fiduciary responsibility and making a decision to invest or not invest in pension funds, in a private equity fund, or hedge fund, that that decision is being made in full disclosure, that that decision is being made with the benefit of tools that would help one evaluate the true value of that asset, so that, in diversifying one's portfolio, the fiduciary can make the best decision for those who depend on that decision.

Our interest here is obviously beyond the philosophical and academic. Our real agenda is to prevent from ever occurring a taxpayer-subsidized bailout of pension funds. Our concern here is that to some extent explicitly and to some extent implicitly the taxpayers of the United States stand behind defined benefit plans in our country. So we not only have an interest in fairness for those who depend on those funds for their income, but we certainly have an interest in protecting the taxpayers of the country against any sort of obligation that would require them to rescue a failed fund.

The best defense against failure is diversification. The best principle of diversification is transparent understanding of the investments through which a fiduciary can invest or not invest. So that is the purpose of our hearing.

I would like to proceed by turning to my friend, the senior Republican on the subcommittee, Dr. Price, for his opening comments, at which time we will then proceed to hear from the witnesses.

Dr. PRICE. Thank you, Mr. Chairman. And I appreciate you holding this hearing.

I want to thank also the members of the panel. We look forward to your comments today and appreciate you taking the time to share with us your expertise.

This is a remarkably critical issue. Some pension plans are experiencing funding shortfalls after the economic downturn, and plan sponsors are trying to find greater returns to meet their obligations.

However, I share with some of my colleagues the concern that today we will be hearing testimony and recommendations, some of which are based upon a government report that is almost 2 years old. That is essentially before the financial crisis occurred and without any of the recent statutory changes made in the Dodd-

Frank Act, which, candidly, will have huge consequences, many of which may not be helpful to the state of pensions.

Nevertheless, we welcome the opportunity to look at this issue further in an effort to better understand any potential problems.

The ERISA statute provides a longstanding framework to guide the activities of private pension plans and the people acting in a fiduciary capacity for those plans. Generally, a pension plan fiduciary, the person charged with running the plan and making those pivotal decisions, must act prudently in determining a pension plan's obligations and ensure that sufficient assets exist to meet those obligations.

Part of that obligation includes making good investment decisions. Pension plans commonly spread their investments across a wide variety of investment vehicles: stocks, bonds, mutual funds. Diversification helps pension plans avoid catastrophic losses and helps secure reasonable rates of return.

Congress has historically encouraged diversification of pension assets and has mostly avoided mandating how private pensions invest their assets, leaving many of those details to those financial professionals responsible for the pension plans.

As we will hear today, there are many different ways to invest pension assets, including some nontraditional vehicles, such as hedge funds and private equity. We will learn about different types of alternative products, how they operate and help pension plans achieve their objectives, whether our witnesses believe that new regulations are advisable, how different States may enable or curtail pension plan investment in alternative products, and whether the new financial services law might shed some light on the operations of certain funds like hedge funds.

When looking at the bigger picture, though, it is important to note that our economic system generally provides greater rewards and potentially greater losses for those who take greater risks. While the vast majority of pension investments are made by highly sophisticated financial advisors investing in good faith in legitimate private investments funds, this ultimately helps all pensioners receive their promised benefits.

Have there been some bad actors? Absolutely. However, we should be careful at this hearing not to implicate an entire industry due to the conduct of a small number of unscrupulous individuals. These issues are too important and consequential to the majority of Americans to rush to action or draw incorrect conclusions that might limit the choices for pensioners or flexibility in their decision-making.

Mr. Chairman, I thank you. And I look forward to our hearing and hearing from the witnesses and the questions that will follow.

[The statement of Dr. Price follows:]

Prepared Statement of Hon. Tom Price, Ranking Republican Member, Subcommittee on Health, Employment, Labor, and Pensions

Good morning and thank you, Chairman Andrews. I would like to begin by thanking our distinguished panel for appearing today. We appreciate that they have taken time out of their busy schedules to share their experiences and expertise with us.

This is a critical issue. Some pension plans are experiencing funding shortfalls after the economic downturn, and plan sponsors are trying to find greater returns to meet obligations. However, I am somewhat concerned that we will be hearing testimony and recommendations today based on a government report that's almost two

years old. That's essentially before the financial crisis occurred and without any of the recent statutory changes made by the Dodd-Frank Act—which, candidly, will have huge consequences, many not helpful, to the state of pensions. Nevertheless, we are open to examining this issue in an effort to better understand any potential problems.

The ERISA statute provides a longstanding framework to guide the activities of private pension plans and the people acting in a fiduciary capacity for those plans. Generally, a pension plan fiduciary, the person charged with running the plan and making those pivotal decisions, must act prudently in determining a pension plan's obligations and ensure that sufficient assets exist to meet those obligations. Part of that obligation includes making good investment decisions.

Pension plans commonly spread their investments across a wide variety of vehicles, including stocks, bonds and mutual funds. Diversification appears to help pension plans avoid catastrophic losses and helps secure reasonable rates of return. Congress historically has encouraged diversification of pension assets and has mostly avoided mandating how private pensions invest their assets, leaving many of the details to those financial professionals responsible for pension plans.

As we'll hear today, there are many different ways to invest pension assets—including some non-traditional vehicles such as hedge funds and private equity. We'll learn about different types of alternative products, how they operate and help pension plans achieve their objectives, whether our witnesses believe that new regulations are advisable, how different states may enable or curtail pension plan investment in alternative products, and whether the new financial services law might shed some light on the operations of certain funds, like hedge funds.

When looking at the bigger picture, it is important to note that our economic system generally provides greater rewards, and potentially greater losses, to those who take greater risks. Now, the vast majority of pension investments are made by highly sophisticated financial advisors investing in good faith in legitimate private investment funds. This ultimately helps all pensioners receive their promised benefits. Have there been some bad actors? You bet. However, we should be careful at this hearing not to implicate an entire industry due to the conduct of a small number of unscrupulous individuals.

These issues are much too important and consequential to the majority of Americans to rush to action or draw incorrect conclusions that might limit the choices for pensioners or flexibility in their decision-making.

Thank you, Mr. Chairman. I look forward to hearing from our witnesses and exploring these matters further in the questioning period.

Chairman ANDREWS. I thank my friend.

And, without objection, opening statements from any other member of the subcommittee will be entered in the record at this point.

[The statement of Mr. Kucinich follows:]

Prepared Statement of Hon. Dennis J. Kucinich, a Representative in Congress From the State of Ohio

I would like to thank Chairman Andrews for holding this hearing and for his continued commitment to protecting the retirement security of workers.

Pensions are predicated on trust. They are agreements between employees and their employers to provide for the retirement of the employees after they have fulfilled their service. When that trust is violated, it is the workers, through no fault of their own, who are left holding the bag.

Case in point:

In Ohio, our Attorney General has been fighting AIG for years to get back public pension funds lost due to bid rigging, accounting fraud, and market manipulation. Ohio was the lead plaintiff in a class action suit that attempted to recover millions of dollars for the pension plans of teachers, firefighters, and police officers.

AIG recently settled the lawsuit for $725 million, which means that the people who teach our children and protect our communities will finally have received the compensation for crimes perpetrated against them.

I am pleased that AIG finally decided to negotiate in good faith with Attorney General Richard Cordray after years of stalling, and after being called to account publicly in Congressional hearings.

But we all know that cases like this are only the tip of the iceberg, and for the thousands of Ohioans who have been made whole by this decision, there are millions

of Americans out there whose retirement security has been compromised by questionable investments or outright washed down the drain by fraud and lies.

I look forward to working with Chairman Andrews to make sure that Congress does its part to make sure that pensioners are protected and that plan sponsors have the information they need to make responsible decisions.

Our constituents deserve better than what many of them have received in the past. They choose pension plans precisely because of the security that defined benefits offer in retirement. We must do everything in our power to make sure that the rug cannot be pulled out from underneath them.

Chairman ANDREWS. We will now proceed to introduce the witnesses. I am going to read a brief biography for each of you.

You should know that your written statements, which we have received in advance and appreciate, will be entered, without objection, into the record of the hearing. We ask you to provide us with an approximately 5-minute oral summary of that written statement so that we can then proceed to the question and answer session with the members of the committee.

So I am going to read the biographies in order of the witnesses' testimony, and then we will proceed.

Mr. Matthew D. Hutcheson is an independent pension fiduciary. His clients include the plans of Fortune 100, 500, and 1,000 companies, mid- and small-sized companies, government and legal accounting firms. Mr. Hutcheson received his MS from the Institute of Business and Finance and earned further accreditation from the University of Pittsburgh, Texas Tech University, and the American Academy of Financial Management.

Mr. Hutcheson, welcome to the committee.

We are pleased to welcome back Ms. Barbara D. Bovbjerg, who is the director of education, workforce, and income security issues at the United States Government Accountability Office. At the GAO, she oversees evaluative studies on age and retirement income policy issues, including Social Security, private pension programs, and other issues. Ms. Bovbjerg holds a master's degree in public policy from Cornell University, an outstanding school, and a BA from Oberlin College.

You can guess that both Mr. Walker and myself are graduates of Cornell Law School—not the only reason that you are here.

We are pleased to welcome back to the committee Mr. Robert Chambers, a partner at McGuireWoods, LLP. Mr. Chambers counsels employers and executives in connection with tax-qualified retirement plans, including 401(k) plans, cash balance and pension equity plans, and ESOPs. He received his JD from Villanova University Law School and a BA from Princeton University, located in the finest State in America, New Jersey.

We appreciate that, Mr. Chambers. Mr. Holt, I am sure, would appreciate that, as well, since he represents Princeton.

And, finally, Mr. John Marco is chairman of the Marco Consulting Group. He began his career as an investment consultant in 1977, when he joined A.G. Becker, Incorporated. Mr. Marco received his BS in mathematics from Lewis University and continued his graduate studies at Purdue, Northwestern, and Northern Illinois Universities.

To each of our witnesses, welcome to the subcommittee.

Three of you, I know, have been here before. I think, Mr. Hutcheson, this is your rookie appearance here, is that right?

The way the rules work is that, in front of you, you see a box. When you begin your testimony, the green light will go on. When you have 1 minute left in your 5, the yellow light will go on. And the red light signifies the end of the 5 minutes, and we would ask you to summarize so we can get to questions.

And so, Mr. Hutcheson, if you would turn your microphone on, we will begin with you. We welcome you to the committee.

STATEMENT OF MATTHEW D. HUTCHESON, PROFESSIONAL INDEPENDENT FIDUCIARY

Mr. HUTCHESON. Thank you. I appreciate the opportunity to be here.

Chairman Andrews, Congressman Price, and members of the subcommittee, my name is Matthew Hutcheson. I am a professional independent fiduciary. Retirement plan sponsors may appoint me to serve as the responsible decision-maker for their plans to fulfill those often complex and time-consuming obligations. In my role as fiduciary, I have made decisions directly affecting the lives of hundreds of thousands of plan participants, of hopeful retirees expecting to receive many billions' worth of future benefits.

We live in an increasingly volatile and uncertain business world. As a result, many plan fiduciaries are exploring alternative investments to improve portfolio performance and reduce risks. It is likely that interest in alternative investments will continue to spread, not only for the potential merit of the alternative investment alone, but particularly due to concerns about the economy and Wall Street's integrity, even in the face of sweeping legislative reform. There is significant financial industry fatigue, and alternative investments offer a sense of hope for some.

Generally speaking, an alternative investment means any investment vehicle except stocks, bonds, mutual funds or similar funds comparable to mutual funds, cash, or properties. Examples of alternative investments may include tangible assets such as gold or art, commodities, private equity funds, hedge funds, and closely held stocks.

Other examples of alternative investments, although not usually referred to as such, are derivatives and guru portfolios. Derivatives are those speculative instruments that brought down Lehman Brothers and Bear Stearns and nearly destroyed our financial system. Guru portfolios are so-called investment strategies based on special knowledge and expertise the guru is purported to have. That is how the guru claims it can outperform its competitors.

Gurus play to the investor's ego, making the investor feel special and smart for knowing the guru and for being permitted to invest with him or her. Many times the guru is falsifying accounting records to make the investment performance appear better than it is. Investors' attention becomes focused on short-term gains instead of long-term values. Bernie Madoff is the most famous example.

The due diligence burden retirement plan fiduciaries have when investigating alternative investments is significantly higher than it is for publicly traded securities, for obvious reasons. It requires greater knowledge and insight into relevant issues. Most fidu-

ciaries of employer-sponsored plans are ill-prepared to perform an appropriate level of due diligence. While the plan itself is considered to be an accredited investor, individual fiduciaries might not otherwise be. The participants in a plan are vulnerable to the decisions made by that fiduciary.

There are several reasons that performing due diligence and proper monitoring of alternative investments is so difficult. First, the fair value of the investment may be difficult to determine. Even when a fair value is assigned to an investment, its validity may be subject to debate. For example, the reported fair value of an investment could reasonably change by changing one or more unobservable inputs that could have a reasonably material impact on calculating the fair value under those circumstances.

Unobservable inputs are assumptions the investment manager makes based on what he or she believes potential investors will pay for an interest in that investment. Those assumptions are based upon the best information available at the time given specific circumstances affecting that investment. However, there may be multiple unobservable inputs that are equally valid that materially change the calculated fair market value.

There are other reasons why performing due diligence on alternative investments is tricky for fiduciaries. One is limited historical information. The second is the difficulty in obtaining an expected return, which is the basis of capital markets. Without an expected return, fiduciaries are unable to determine the merit of a particular investment. In order to properly govern a retirement plan, the portfolio must be structured in such a way as to produce that expected return in a diversified portfolio.

So there are four practical ways to protect retirement plan participants from the inherent accounting valuation and due diligence challenges provided within the alternative investment framework.

First, require audit of internal controls that are normally required for publicly traded companies; require them for hedge funds and private equity funds. Number two, require understandable financial statements. We receive financial statements that are frequently difficult to understand. Number three, ensure that managers of alternative investments have solid enterprise risk management skills. And, finally, improving fair value measurement methods.

And I will explore all of these in greater detail throughout the hearing.

[The statement of Mr. Hutcheson follows:]

Prepared Statement of Matthew D. Hutcheson, Professional Independent Fiduciary

Chairman Andrews, Congressman Price, and members of the Committee. My name is Matthew Hutcheson. I am a professional independent fiduciary. Retirement plan sponsors may appoint me to serve as the responsible decision maker for their plans to fulfill those often complex and time consuming obligations. In my role as fiduciary, I have made decisions directly affecting the lives of hundreds of thousands of hopeful retirees expecting to receive many billions worth of future benefits.

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It is likely that interest in alternative investments will continue to spread, not only for the potential merit of the alternative investments alone, but particularly due to concerns about the economy and Wall Street's integrity, even in the face of

sweeping legislative reform. There is significant "financial industry fatigue," and alternative investments offer a sense of hope for some.

Generally speaking, an alternative investment means any investment vehicle other than stocks, bonds, mutual funds, cash or real estate. Examples of alternative investments may include tangible assets (i.e. gold or art), commodities, private equity funds, hedge funds, and closely held stocks.

Other examples of alternative investments, although not usually referred to as such, are derivatives and "guru portfolios."

Derivatives are those speculative instruments that brought Lehman Brothers and Bear Sterns down, and nearly destroyed our financial system.

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"Gurus" play to the investor's ego; making the investor feel special and smart for knowing the guru, and being "permitted" to invest with him or her. Many times, the guru is falsifying accounting records to make the investment performance appear better than it is. Investor's attention becomes focused on short term gains instead of long term values. Bernie Madoff is the most famous example.

The due diligence burden retirement plan fiduciaries have when investigating alternative investments is significantly higher than it is for publicly traded securities, for obvious reasons. It requires greater knowledge and insight into relevant issues. Most fiduciaries of employer sponsored retirement plans are ill prepared to perform an appropriate level of due diligence. While the plan itself is considered to be an "accredited investor,"[1] individual fiduciaries might not otherwise be. The participants in the plan are vulnerable to the decisions made by the fiduciary.

There are several reasons that performing due diligence and proper monitoring of alternative investments is so difficult. First, the fair value of the investment may be difficult to determine. Even when a fair value is assigned to an investment, its validity may be subject to debate. For example, the reported fair value of an investment could reasonably change by "changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances."[2]

"Unobservable inputs,"[3] are assumptions the investment manager makes based upon what he or she believes potential investors will pay for an interest in the investment. Those assumptions are to be based upon the best information available at the time, and given the specific circumstances affecting the investment. However, there may be multiple unobservable inputs that are equally valid, but that materially change the calculated fair market value.

Unobservable inputs are not transparent to potential investors. That's why they are called "unobservable." They can lead investors to incorrect conclusions and even significant investment losses, even when all parties are otherwise acting in good faith.

There is another reason performing due diligence on alternative investments is tricky for fiduciaries. Often, only limited historical information is available on the investment. The historical behavior of an investment is the basis for return on capital expectations, and also expected levels of risk and volatility. It also makes monitoring against a benchmark virtually impossible.

"Expected return"[4] is the foundation of capital markets. If investors are unable to expect something favorable in return for the investment of their capital, the market system would cease to function properly. The flow of investment dollars would dry up, and the capital markets would freeze.

Assets in a retirement plan are held in trust for the future retirement income of plan participants and beneficiaries. Creating and securing retirement income is the overarching objective of ERISA. In order to properly govern a retirement plan, the portfolio must be structured in such a way to produce an expected return over a defined investment time horizon. If a fiduciary does not know what to expect in return for the investment of trust assets, it is in the realm of speculation. A fiduciary would also be unable to fairly compare two or more alternative investments.

Fiduciaries are obligated under current regulation[5] to avoid imprudent speculation by applying proper principles of economics and finance to portfolio construction and management. Thus, a lack of historical information can pose a significant challenge, if not a road block altogether, for fiduciaries considering a particular alternative investment.

Finally, the cost of buying and selling alternative investments can be very high. Those costs can be difficult to quantify, and are not frequently disclosed in an easy to understand format.

There are four practical ways to protect retirement plan participant's future retirement income from the inherent accounting, valuation, due diligence, and trading challenges presented by alternative investments.

1. Require audit of internal controls: Require that alternative funds have an independent auditor sign off on internal controls based upon the Committee of Sponsoring Organizations' ("COSO") definition of what it means to effectively evaluate internal controls.[6] Auditing internal controls today isn't as time-consuming or as costly as it was when large public companies first began complying with one of the most onerous requirements of the 2002 Sarbanes-Oxley Act, known as Section 404. Although the Sarbanes-Oxley Act is directed at public companies, many privately owned companies and nonprofit organizations are electing to evaluate their systems of internal control using COSO's framework.[7] Alternative investment managers can too.

2. Require understandable financial statements: President Obama is quoted as saying, "I think we have to restore a sense of trust, transparency and openness in our financial system."[8] It is urgent that we do so. It starts with creating financial statements that retirement plan fiduciaries can actually understand. Retirement plan fiduciaries want a "plain English" executive summary to an investment's annual report and more complete disclosures.[9] Indentifying a reasonable expected return on capital will otherwise be difficult at a minimum and perhaps even impossible based on what those familiar with such matters would otherwise require before proceeding with an investment.

3. Enterprise risk management skills: Strong enterprise risk management skills should be the hallmark of every alternative investment management team. Fiduciaries considering alternative investments must possess sufficient knowledge themselves to investigate whether alternative investments are being managed by individuals with such skills. There must be a common, standardized language between all alternative investment managers, auditors, and plan fiduciaries. Key principles, concepts, and guidance must be conveyed under a common framework.[10] A fiduciary's ability to accurately compare two or more competing alternative investments depends on it. That will restore investor confidence and give retirement plan participants and retirees the protections they deserve.

4. Fair Valuation Standards: The Financial Accounting Standards Board recently published proposed amendments to its fair value measurement and disclosure rules. An explanation can be found on the Board's website.[11] The proposed amendments enhance and standardize the method of valuing alternative investments by the U.S. based Generally Accepted Accounting Principles (GAPP) and the International Financial Reporting Standards (IFRSs). It focuses on standardizing how elements of uncertainty that may affect a fair market value are disclosed. For example, disclosure of the use of one unobservable input over another in a fair market valuation, and how it might have affected the resulting value. This is particularly important for plan fiduciaries investigating the merits of international alternative investments. Legislation could augment those rules with respect to employer sponsored retirement plans. That would enhance confidence that the integrity of valuation method being applied to several considered alternative investments is sound.

In conclusion, perhaps the most important participant-protecting skill is application of the fiduciary standard. For example, in my capacity of a professional fiduciary, I have never permitted trust assets to be invested with Madoff, Bear Sterns, or any other alternative investment that failed to meet a fiduciary smell test. While many sophisticated institutional and high net-worth investors lost billions with Madoff, not one participant under my fiduciary jurisdiction has ever been exposed to Madoff, Bear Stearns, failed hedge funds, or other investments such as those. The fiduciary standard of care, coupled with clear evidence of risk management skills, internal controls, and demanded transparency protected my participants. This committee can develop policy intended to help all other fiduciaries apply the same due diligence expertise of alternative investments.

Thank you.

ENDNOTES

[1] *http://www.sec.gov/answers/accred.htm*

[2] FASB Issues Proposed Update on Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. CAQ Alert #2010-41—July 14, 2010

[3] CPA Journal. *http://www.nysscpa.org/cpajournal/2006/1106/infocus/p14.htm*

[4] *http://www.investorwords.com/1840/expected—return.html*

[5] Application of modern investment principles in qualified retirement plans. [Labor Reg. § 2550.404a-1 (42 FR 54122, 1977)], [ERISA Reg. § 2550.404a-1], ERISA Interpretive Bulletin 94-1, etc.

[6] *http://mcgladreypullen.com/Resource—Center/Audit/Articles/WhatIsCOSO.html*

[7] "Turbo Charge Your SOX Program With the New COSO Monitoring Guidance." July 8, 2010 by Stephen Austin, CPA, MBA. www.cpa2biz.com.

[8] *http://wallstreetpit.com/2430-improving-transparency-regaining-investors-trust*

[9] "A number of dialogue tour participants proposed adding a "plain English" executive summary to annual reports. Others suggested that "click-down" online technology could let users control how deeply they delve into a particular company's public reports. We also found considerable support for more complete and understandable disclosures on executive compensation. In short, investors have made it clear that they want more transparency." *http://www.icahnreport.com/report/2009/01/improving-transparency-regaining-investors-trust.html*

[10] *http://www.coso.org/Publications/ERM/COSO—ERM—ExecutiveSummary.pdf*

[11] *http://www.fasb.org/cs/ContentServer?c=FASBContent—C&pagename=FASB%2FFASBContent—C%2FNewsPage&cid=1176156961430*

Chairman ANDREWS. Mr. Hutcheson, thank you.

You should be aware that Members have had your written testimony and had ample time to read it. I read it, and so you can assume that we have had the opportunity to read your complete statement. Thank you.

Ms. Bovbjerg, welcome back to the committee. Thank you again for the outstanding work the GAO does on a range of issues across the country and across the issues. I am always impressed by the thoroughness and dedication you and your colleagues show to every question you confront. It is good to have you back.

STATEMENT OF BARBARA BOVBJERG, DIRECTOR OF EDUCATION, WORKFORCE, AND INCOME SECURITY, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Ms. BOVBJERG. Thank you so much, Mr. Chairman. I will report back on your kind remarks.

I am particularly pleased to be here today to speak about pension plan investment in hedge funds and private equity. It is such an important issue. Millions of Americans rely on defined benefit plans for their financial wellbeing in retirement. And it is particularly important that plan fiduciaries choose wisely in investing plan assets, to ensure that plans are adequately funded today and in the future.

My testimony focuses on the extent to which plans have invested in hedge funds and private equity, the challenges they face in making such investments, steps sponsors can take to address the challenges, and measures government can take. My statement updates our 2008 report on this topic.

First, the extent of these investments. The frequency of DB plan investment in hedge funds has grown dramatically, with 51 percent of large plans holding hedge funds in their portfolios today, up from 11 percent in 2001. Yet the vast majority of these plans invest less than 10 percent of their assets this way.

The picture is a little different for private equity investment. Although 90 percent of large plans invest in private equity today, over 70 percent of them did this in 2001. So this type of investment has been consistently fairly common, at least among large plans. But as with hedge funds, most plans do not concentrate their assets in this form of investment.

Let me turn now to the challenges these investments present. Although plan fiduciaries have told us that they invest this way to diversify while gaining potentially significant returns, they face several major challenges: foremost, the uncertainty over the current value of their investment.

Unlike stocks and bonds, which have a readily determined market price, hedge fund and private equity investments are more

opaque to investors. Hedge funds generally do not provide information on either the nature of the underlying holdings or the aggregate value on a day-to-day basis. Hedge fund managers may decline to disclose information on asset holdings and their value if they believe the disclosure could compromise their trading strategy.

Similarly, private equity investment valuation is often uncertain during the fund's cycle, which can be up to 10 years or more. Plan fiduciaries often won't know the value of the underlying investment until the holdings are sold.

Investment risks are also greater than from more traditional investments. For example, hedge fund and private equity managers may make relatively unrestricted use of leverage. While leverage can magnify profits, it can also magnify losses.

Further, the success or failure of these funds can by greatly affected by their managers. Obviously, a managerial investment mistake can cause losses, but there are also operational risks of mismanagement, such as internal control weaknesses that open the door to fraud. And this underlines the importance of annual audits, which encourage robust operational and internal control processes.

Finally, these investments are generally illiquid, making it difficult, if not impossible, for plans to cut their losses in the event of mishap. While the DB plan sponsor is responsible for assuring plan funding levels, not the participant as with 401(k)s, a significant drop in funding could ultimately affect the viability of the DB plan and, by extension, the retirement benefits participants that have been promised.

Plan fiduciaries told us they take measures to protect themselves from these risks by making careful and deliberate fund selection at the front end. But, of course, the success of this approach depends on how good the fiduciaries are at such decision-making and how much information they have going in.

Savvy fiduciaries negotiate key terms of investments with these funds, specifying fee structure and conditions, valuation procedures, redemption provisions, and degree of leverage to be employed. Some told us they look to funds of funds to expand their diversification, although these are often less transparent than single hedge funds and can come with an additional layer of fees.

So there is a lot to be considered as a plan fiduciary seeking to invest in such funds, and we think the Federal Government can help. In 2008, 2 years ago, we recommended the Department of Labor provide guidance on the unique challenges of these investments and outline prudent steps plan fiduciaries could take. We felt this could help all plans that consider such investments and, in fact, might warn smaller plans away if they don't have the resources to carry out the oversight that is needed. We still believe that this would be an important contribution for the Department to make, but, although they said they would consider the feasibility of our recommendation, they have taken no action as of yet.

I would like to conclude by noting that plan sponsors are facing tremendous financial pressures, both overall and in maintaining funding levels in their DB plans. Congress has provided temporary relief from ERISA funding rules, but the pressure to achieve high returns on plan assets has got to be significant, especially if a fail-

ure to achieve such returns means higher required contributions from the sponsor.

It will be increasingly important to help fiduciaries do the right thing by making them aware of the risks associated with alternative investments as well as ways to manage their stake in these investments. Guidance from Labor and better information from the investment managers themselves cannot, of course, protect plan assets from poor decision-making, but it can better armor fiduciaries and, by extension, plan participants against large losses resulting from a poor understanding of what they are getting into.

And that concludes my statement, Mr. Chairman.

[The statement of Ms. Bovbjerg may be accessed at the following Internet address:]

http://www.gao.gov/new.items/d10915t.pdf

Chairman ANDREWS. Thank you again, Ms. Bovbjerg.

Mr. Chambers, welcome back to the committee. It is a pleasure to have you with us.

STATEMENT OF ROBERT CHAMBERS, PARTNER, MCGUIREWOODS, LLP

Mr. CHAMBERS. Thank you, Chairman, and thank you, Dr. Price and members of the committee.

First and foremost, let me express my profound appreciation to the committee for an opportunity to spend a few hours thinking about something other than health reform. It has been terrific. But I also appreciate the opportunity to present testimony with respect to the investment of DB plan assets in hedge funds, private equity funds, and other alternative investments.

DB plans must continue to provide participants with promised retirement security despite these turbulent economic times. Our national priority should be a DB plan system that functions transparently, as you indicated, Mr. Chairman, and provides promised benefits, but without nonessential administrative burdens and unnecessary costs that would undermine their essential purpose.

So I am going to make a few points, if I may. The first relates to the GAO report from 2008 on the investment of DB plan assets in these kinds of investments.

I think that the GAO report itself was something of a hedge. And I think that it was an important position for them to take, and I think that it was actually pretty smart. The report took great care, as did Ms. Bovbjerg just now, to describe both the challenges and the unique opportunities presented by these types of investments. So, for example, she indicated and the report indicated that a growing number of plans have begun to invest in hedge funds and private equity, but virtually all of them have invested only a small portion of their total plan assets.

Similarly, while many hedge fund and private equity investments may carry increased risks, virtually all the fiduciaries interviewed indicated that they were generally pleased with the overall results of those investments and that they were willing to devote the necessary time and energy to vet those investments in order to increase overall asset returns and, of course, to reduce volatility.

The GAO report did not suggest that any restrictions be placed on nontraditional investments by DB plans or that additional protective legislation would be required. Instead, it recommended that DOL apprise plan fiduciaries of the risks of such investments and the need for increased due diligence, negotiations, and monitoring in accordance with ERISA's existing fiduciary rules.

Which leads to my second point, and that is that the guidance that the GAO has suggested is generally available currently from other sources. The DOL expressed concern that providing this guidance would be difficult in light of the lack of uniformity in those investments. But I think that help is on the way. First, the SEC is likely to provide help as it issues regulations and other guidance under the Dodd-Frank financial reform bill. And in the interim, the DOL could easily make available to plan fiduciaries the existing work of, frankly, many sophisticated nonpartisan groups that have developed excellent tools for handling the due diligence and contract negotiations for these kinds of investments. And I have referred to one of these reports in my written testimony.

My third point is that the Dodd-Frank bill will require many plan advisors to register with the SEC and to provide information regarding their funds. The bill will give the SEC broad new powers with respect to managers of many hedge funds and possibly private equity funds, and the SEC and FSOC and other regulators will provide guidance on definitions, registration requirements, and the periodic filing of confidential information for many of these funds.

In light of the recent passage of the bill, neither Congress nor the DOL should act at this time, in my view, to restrict DB plans from investing in these kinds of funds.

And next are the valuation issues that others have already addressed. And I think that these valuation issues are, in fact, being addressed. Form 5500 and plan actuaries require an annual determination of the fair market value of DB plan assets. So all investments for which there is no public market or reported unit sales, including hedge funds and private equity funds, present valuation challenges that I think are manageable, albeit somewhat thorny.

Other groups are working on the issue. Again, the SEC is likely to develop valuation techniques as part of its guidance under the Dodd-Frank bill. And, also, the Financial Accounting Standards Board and the accounting industry are developing a systematized approach to the valuation of downstream investments for which there is no public market.

My last point is that plan participants do not need additional information on any of these kinds of investments either. Again, the Pension Protection Act requires defined benefit plan administrators to provide annual funding notices to participants that include a year-end market valuation of the plan's assets and liabilities as well as information regarding funding and investment policies. The DOL has already issued a model notice that is relatively short and easy, I think, for participants to understand. I don't believe that there is any need to provide even more information that could render the existing disclosure regime completely meaningless.

And one last thought, if I may. The DOL has consistently advised plan sponsors and other fiduciaries of the importance of process. You are supposed to create appropriate procedures, follow the pro-

cedures, review the procedures from time to time to determine that they remain best practices, and then document your compliance and review. Fiduciaries are to be judged primarily on their adherence to this process rather than on the result of their individual decisions. And the decision whether to invest DB assets in hedge funds or other alternative investments, as well as the monitoring of those investments, should not be held to a different standard.

Thank you.

[The statement of Mr. Chambers follows:]

Prepared Statement of Robert Gordon Chambers, on Behalf of McGuireWoods, LLP

My name is Robert Chambers, and I am a partner in the international law firm of McGuireWoods LLP. I have advised clients with respect to defined benefit plan issues since shortly after ERISA became effective. In that regard, my clients have included both large and small employers that sponsor defined benefit plans as well as financial institutions and other organizations that provide services to such plans. I am also a past chair of the Board of Directors of the American Benefits Council.

I appreciate the opportunity to present testimony with respect to the investment of defined benefit plan assets in hedge funds and private equity funds. Despite the general decline of the defined benefit ("DB") plan system, the investment of assets and funding of those DB plans that remain in effect have taken on increased importance for millions of Americans during difficult economic times. It is more important than ever to ensure that DB plans provide their participants with the retirement security that they promise. Our national priority should be an effective DB plan system that functions in a transparent manner and provides promised benefits, but without nonessential administrative burdens and unnecessary costs that would undermine the paramount purpose of the plans.

Due to the breadth of this hearing's topic, I have tried to anticipate several issues that may be discussed, and I apologize if I have failed to cover any of the intended issues.

My testimony will relate to the following subjects:

- The findings, conclusions, and recommendation reached in the April, 2008 report of the Government Accountability Office ("GAO") on investment of DB plan assets in hedge funds and private equity—GAO-08-692.
- The existence of other reports that the Department of Labor ("DOL") may use to provide guidance to plan fiduciaries regarding the decision-making process for such investments.
- The provisions of the Dodd-Frank financial reform bill that will require additional disclosure regarding hedge funds and private equity.
- The impact of such investments on other plan service providers.
- The existence of sufficient DB plan asset disclosure to participants.

The GAO Report Generally Reaches Logical, But What Are Now Dated Conclusions

The GAO necessarily hedged its view in developing the results and conclusions in its August 2008 report. It determined that:

- A growing number of plans have begun investing in hedge funds and private equity, yet most of such plans only invested a small portion of total assets in such investments.
- Many hedge fund and private equity investments appear to have more risk associated with them, yet virtually all of the fiduciaries interviewed indicated that they were generally pleased with the results of those investments.
- Hedge fund and private equity investments often require more due diligence to obtain necessary information and more negotiation of contract terms in order to make an informed investment decision, yet many fiduciaries are willing to devote this time and energy to the task in order to achieve the overall returns and volatility reduction that those investments can provide in accordance with a DB plan's funding and investment policy.
- Hedge fund and private equity investments often require longer term commitment and less liquidity than other types of investments, yet such fiduciaries deem those features to be less problematic in the context of projected liquidity needs in DB plans, especially in light of the opportunity for greater returns and less volatility that those investments, many of which are uncorrelated to traditional plan investments, may provide.

These GAO findings and conclusions certainly echo those of our clients that have explored investments in hedge and private equity funds.

The GAO report provides, correctly, that ERISA's fiduciary rules apply equally to both large and small DB plans, but that smaller DB plans may not have the resources to perform sufficient due diligence to properly assess non-traditional investments such as hedge and private equity funds. However, the report does not suggest that restrictions be placed on smaller plans. Rather, the report recommends that smaller plans should simply be apprised of the risks of such investments and the need for increased due diligence, negotiations, and monitoring to comply with ERISA's fiduciary rules.

If the DOL Decides to Provide Guidance to Plan Fiduciaries Regarding the Decision-Making Process for Investments in Hedge and Private Equity Funds, That Guidance Is Now Generally Available From Other Sources

The GAO Report concludes with a recommendation that the DOL provide guidance for plan fiduciaries that covers the special challenges relating to investments in hedge funds and private equity and the due diligence and other procedures that fiduciaries should undertake to address these challenges. The report also suggests that the DOL provide additional information on these investments for small DB plans.

The DOL was provided an advance copy of a draft of the GAO report and responded that it foresaw a number of problems with satisfying the GAO's suggestion. The DOL's foremost concern was that providing such guidance would be extremely difficult in light of the lack of a uniform definition of such investments and the lack of uniformity of such funds and their underlying investments.

This concern may be put to rest in part because we can expect the SEC to provide definitional help as it issues regulations and other guidance under the Dodd-Frank financial reform bill discussed below. Further, as we await the issuance of this guidance, I believe that the DOL may make available the guidance suggested by the GAO without needing to reinvent the wheel and becoming entangled in a definitional morass. There are a number of existing, recent publications containing guidance on investing in hedge funds and private equity, several of which were drafted in connection with public sector initiatives.

For example, I draw your attention to Principles and Best Practices for Hedge Fund Investors, the Report of the Investors' Committee to the President's Working Group on Financial Markets. The report is dated, January 15, 2009. This document is available, among other places, on the Treasury Department's website.

This report includes a Fiduciary's Guide and an Investor's Guide. The Fiduciary's Guide provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The Investor's Guide provides recommendations to those charged with executing and administering a hedge fund program once a hedge fund has been added to the investment portfolio. The principles and best practices are applied uniformly to both large and small investors.

The membership of the Investors' Committee included representatives of private and university endowments, large governmental and private pension funds, unions, and asset management firms.

My point simply is that the DOL could easily and quickly make available to plan fiduciaries the existing work of sophisticated, non-partisan groups that have developed excellent tools for handling the due diligence and contract negotiations for investments in hedge and private equity funds.

The Dodd-Frank Wall Street Reform and Consumer Protection Act Will Require Many Advisers To Hedge and Private Equity Funds to Register With the SEC and Provide Information Regarding the Funds

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank bill", which has not been signed by the President at the time that this testimony has been prepared), imposes registration and other disclosure requirements on many hedge funds and possibly on private equity funds. The Dodd-Frank bill gives the Securities and Exchange Commission ("SEC") broad new powers with respect to managers of hedge and private equity funds. My firm expects that the SEC, the Financial Stability Oversight Council, and other regulators will provide needed guidance on definitions, registration requirements for larger advisors, the provision of required confidential data for virtually all of these funds, and methods of determining whether such funds are undertaking undue risk. Those agencies are authorized to take action against those advisers that are determined to have undertaken too much risk. This will assist the agencies in their attempts to monitor the hedge

funds and private equity industries that grown so exponentially in the past few years.

Neither Congress nor the DOL should act at this time to restrict or prohibit DB plans from investing in any type of hedge or private equity funds. Plan sponsors are concerned such action would:

- Substitute Congress' current judgment regarding investments for the judgment of plan fiduciaries, who are familiar with their workforce and DB plan investment policies, liability management, funding issues, and administration;
- Establish an investment rule based on today's thinking that does not take into account future investment trends and principles;
- Lead to controversy and confusion (especially in the case of hedge funds), regarding whether a particular series of investments creates a restricted or prohibited hedge fund;
- Send a signal to fiduciaries that particular investment options should be preferred over others; and
- Undercut consideration of a plan's funding and investment goals, risk tolerance, and interest in volatility reduction and investment diversification.

There Are Valuation Issues That Must Be Addressed for Some Investments in Hedge and Private Equity Funds

The administrators of all DB plans must make an annual filing of Form 5500 and its related schedules, which require a determination of the fair market value of all plan assets. Further, plan actuaries must obtain a valuation of all plan assets in order to complete their actuarial valuations. Similar to many other types of investments for which there is no public market or reported units sales, hedge funds and private equity investments present valuation challenges that can be difficult but are manageable.

The GAO report also noted the challenges DB plans face in valuing certain investments in hedge and private equity funds.

I expect that the SEC will develop additional valuation techniques as part of the guidance that it issues under the Dodd-Frank bill. I also understand that the Financial Accounting Standards Board and the accounting industry are developing a systemized approach to the valuation of downstream investments for which there is no public market.

More generally, in the United States, the valuation of assets and liabilities of DB plans has never been required to be an exact science. For example, real estate and stock in privately held companies can be appraised, but the valuation cannot be precise. This is not a problem that renders such investments inappropriate for plans, rather it is an issue that plan fiduciaries must consider along with all other factors in deciding to invest in such an asset.

No Additional Information on Hedge and Private Equity Funds Needs To Be Provided To Plan Participants

Congress and the DOL have just reviewed the issue of disclosure of specific information regarding individual investments of a DB plan. The Pension Protection Act amended Section 101 of ERISA to require DB plan administrators to provide annual funding notices to participants that include a year-end market valuation of the plan's assets and liabilities and information regarding the plan's funding and investment policy, among other information. The DOL has issued a model notice that includes a chart illustrating the plan's year-end asset allocation by percentage of plan assets invested in up to 17 categories. To the credit of the DOL, this part of the model notice is relatively short, simple, and easy to understand.

It would be very unhelpful to revisit that issue. I have heard from numerous clients and colleagues that the amount of information being provided to participants has grown so great that participants have on the whole simply stopping looking at the disclosures. To add a set of complex new disclosures would simply reduce the number of participants who actually read what they receive.

The key is enabling plan fiduciaries to make informed decisions on behalf of the participants. That should be our focus, rather than so overwhelming participants with complex information that the disclosure regime becomes meaningless.

It is also important to remember that hedge funds, in particular, are not a separate asset class. Rather, they are a compilation of assets from one or more asset classes. Reforming existing rules to draw participants' attention to specific investments, whether in hedge funds, private equity, or other asset classes (such as real estate), invariably will be more confusing than enlightening.

The DOL has consistently advised plan sponsors and other fiduciaries of the importance of creating appropriate procedures, following those procedures, reviewing the procedures from time to time in light of changes to best practices, and docu-

menting such compliance and review. Fiduciaries will be judged primarily on their adherence to this process, rather than on the results of their decisions. The decision of whether to invest DB plan assets in hedge funds, private equity, and other non-traditional assets, and the monitoring of those investments, should not be held to different standards. Nonetheless, I agree with the GAO report that the DOL would perform a valid public service by providing or making available guidance on specific issues that such investments generate. That guidance, which is already available, will need to be reviewed and updated in the future to take into consideration accounting developments and guidance issued by other agencies as they implement recent legislation.

Chairman ANDREWS. Mr. Chambers, thank you very much for your testimony.

Mr. Marco, welcome to the committee. We are happy that you are with us.

STATEMENT OF JOHN MARCO, CHAIRMAN, MARCO CONSULTING GROUP

Mr. MARCO. Good morning, Mr. Chairman, Dr. Price, and members of the committee.

My name is Jack Marco. I am the chairman of the Marco Consulting Group, an investment consulting firm I founded in 1988. We serve about 400 defined benefit plans as clients. Most are multi-employer, jointly trusteed plans organized under the Taft-Hartley Act and subject to ERISA. In most cases, we serve as an investment consultant, but in many situations we serve as a named fiduciary, where we make the decisions on asset allocation and select investment managers. Our clients' aggregate value is approximately $90 billion.

The employee trustees of the Taft-Hartley plans are electricians and bakers, bricklayers and nurses, janitors and plumbers. They work in our grocery stores and hotels and hospitals. They drive trucks and make clothes and care for the sick. They are the very best our Nation has for building complex construction projects and providing necessary and sometimes critical services.

The employer trustees represent small business and large. They are contractors, HR specialists, labor relation specialists, and representatives of trade associations. While they are not investment professionals, as leaders in their unions and businesses they are smart, successful, accomplished individuals. As trustees, they work tirelessly to provide a solid retirement benefit for their members and their employees, and they accept all of the liabilities of a fiduciary and receive no compensation.

When I first started providing investment consulting services to Taft-Hartley plans in 1977, their investments were overwhelmingly in traditional assets of stocks, bonds, and insurance contracts. I was hired as an investment consultant to help them select and monitor investment firms which would manage their assets. Their investments in publicly traded stocks and bonds were held at a custodian bank and independently valued by them. There was little debate about what they owned, what it was worth, and the risks they were taking.

Today, our clients still own stocks and bonds held in many of the same custodial banks. However, these assets represent about 75 percent of their funds. The remainder are in real estate partner-

ships and commingled funds, private equity partnerships, LLCs, and hedge funds.

On the positive side, these assets have added important diversification to the portfolios and improved returns. On the negative side, many of these strategies have become very complex, with little regulation and government oversight. The trustees are expected to be prudent experts when selecting investments which use these strategies. More than ever, they rely on independent investment consulting firms, such as ours, to educate them on the risks and returns of these approaches, bring them the best managers, and help them avoid the poor ones. That is becoming more challenging every day.

I would like to focus on two of these investment approaches: private equity and hedge funds.

In private equity, the definition of "private" means making investments in companies that are not registered with the SEC as publicly traded securities. They are not generally followed by Wall Street. One of the advantages of private equity is that little is known about these startup companies or privately held institutions; therefore, investors who seek out these companies have greater opportunities for superior return. It is also true that this same lack of information creates risk to investors.

While a manager of a publicly traded equity may hold 50 securities, some private equity managers will hold less than 10 investments. These private equity investments are typically partnerships, the investment manager being the general partner and the pension fund being the limited partner. At the time of investment, there are no investments made yet, and the manager begins the process of looking for companies in which to invest. The investor has to rely on his own due diligence and information provided by the general partner to provide some confidence that the general partner will do well.

Our clients typically meet four times a year to conduct all of the business of the pension fund. They have no capacity and no investment staff to perform that due diligence. Most often, they look to an investment consultant to provide that due diligence for them.

Our process examines private equity managers in great detail—everything from SEC registration, third-party providers, offering memorandums, marketing materials, and the like. We require this information to proceed. However, the general partners are not required to provide it. If they refuse, we move on to another candidate. The general partner moves on to another investor who may not demand these disclosures.

The best general partners provide all that is asked of them and more. The worst general partners rely on slick presentations without appropriate disclosure. The same can be said about disclosures after the pension fund has become an investor.

Again, all of these requirements we place on any partnership we recommend to our clients. Where it is not demanded by the investor, it may not be provided because it is not required by law.

Our preference is for our clients to use private equity fund of funds instead of individual private equity funds. The fund-of-funds structure provides diversification of strategy, geography, and industry. The fund-of-funds manager brings expertise, access and over-

sight, and resources to the investment process and bears full responsibility for the evaluation, selection, and timing of all of these investments.

We believe this due diligence structure and the use of fund of funds is a very effective tool for Taft-Hartley trustees. However, requiring general partners to provide these disclosures would ensure that all investors have the information they need to make intelligent, informed decisions.

On hedge funds, there are over 9,000 hedge funds available for pension fund investors. They include a multitude of strategies: long/short equity, merger arbitrage, relative value, distressed debt, fixed-income arbitrage, and the list goes on.

These are some of the most sophisticated strategies executed in the industry. Consequently, it requires equally sophisticated supervision. That is why we prefer funds of hedge funds for our clients. These are typically partnerships or LLCs that select a group of hedge funds and move in and out of them over time. The investor then owns shares in 30 to 50 hedge funds in a diversified portfolio rather than just a few they would select on their own.

As a result, we focus our analyzing and monitoring on funds of hedge funds. We have developed a list of best practices for funds of hedge funds. Generally, we do not recommend funds of hedge funds that do not adhere to the majority of the best practices.

We also expect fund-of-hedge-fund managers to follow certain best practices in their due diligence and monitoring of underlying hedge funds. Our best practices are divided into four categories: people, investment, operational, and business.

Let me just mention that one of the key things about people: Background checks, history and experience, and operational risk is something that is very key to us. We think that the funds need to hire third-party firms to manage custody, audit, and administration responsibility. We want to also measure the business risk of these institutions.

Let me make clear that these are best practices we believe are appropriate and that we follow. They are not required by law or in regulation.

Finally, we believe the SEC registration should be required for all hedge funds and funds of hedge funds. And, thus, we welcome Congress's passage of the financial reform bill, requiring registration of those funds with $150 million or more under management, as an important step towards that goal.

In conclusion, I would like to say the investment environment that Taft-Hartley fund trustees face today is exponentially more complex than it was when I joined the industry three decades ago. It is very difficult to expect trustees to understand the many investment strategies, but without full and complete disclosure by the investment community, it is nearly impossible for these trustees to do their job of protecting the retirement security of millions of American workers.

From the professional advisor and fiduciary's perspective, I know requiring these disclosures would help us do a better job of scrutinizing these investments. I have also provided the committee with a list of these best practices on private equity and hedge funds on the Web site provided to the committee.

Thank you very much, and I am happy to answer any questions.
[The statement of Mr. Marco follows:]

Prepared Statement of Jack Marco, Chairman, Marco Consulting Group

Good morning Mr. Chairman and Members of the Committee. My name is Jack Marco. I am the Chairman of the Marco Consulting Group, an investment consulting firm I co-founded in 1988. We have nearly 400 benefit plans as clients; most are multi-employer, jointly-trusteed plans organized under the Taft-Hartley Act and subject to ERISA. In most cases we serve as investment consultant but in many situations we serve as a named fiduciary where we make the decisions on asset allocation and select the investment managers. Our clients' aggregate asset value is approximately $90 billion. In terms of assets, we are the largest investment consultant to Taft-Hartley plans in the country. I have been an investment consultant for 33 years.

The employee trustees of Taft-Hartley plans are electricians and bakers, bricklayers and nurses, janitors and plumbers. They work in our grocery stores and hotels and hospitals. They drive trucks and make clothes and care for the sick. They are the very best our nation has for building complex construction projects and providing necessary—in some cases critical—services. The employer trustees represent small business and large. They are contractors, HR specialists, labor relation specialists and representatives of trade associations. While they are not investment professionals, as leaders in their unions and businesses, they are smart, successful and accomplished individuals. As trustees they work tirelessly to provide a solid retirement benefit for their members and their employees. And for this they accept all of the liabilities of a fiduciary and receive no compensation.

When I first started providing investment consulting services to Taft-Hartley plans in 1977, their investments were overwhelmingly in the traditional asset classes of stock, bonds and insurance contracts. I was hired as an investment consultant to help them select and monitor investment firms which would manage their assets. Their investments in publicly traded stocks and bonds were held at custodian banks and independently valued by them. There was little debate about what they owned, what it was worth and the risks they were taking.

Today our clients still own stocks and bonds held in custody by many of these same banks and reported on accordingly. However, these assets now represent about 75% of their funds. The remainder is in real estate partnerships and commingled funds, private equity partnerships, LLC's and hedge funds. On the positive side, these asset classes have added important diversification to the portfolios and improved returns. On the negative side, many of these strategies have become very complex with little regulation and government oversight. The trustees are expected to be "prudent experts" when selecting investment firms which use these strategies. More than ever they rely on independent investment consulting firms such as ours to educate them on the risks and returns of these approaches, bring them the best managers and help them avoid the poor ones. That is becoming a more challenging task every day. I would like to focus today on two of these investment approaches: Private Equity and Hedge Funds.

Private Equity

By definition, "private" equity means making investments in companies that are not registered with the Securities and Exchange Commission ("SEC") as publicly traded securities. They are not generally followed by Wall Street analysts. Much has been written about the "Efficient Market Theory" which says there is so much information available about publicly traded companies that there is little opportunity for a money manager to provide above market returns. One of the advantages of Private Equity is that little is known about these privately held or startup companies, therefore the investor who seeks out these companies has greater opportunity to provide superior returns. It is also true that this same lack of information creates a risk to investors. Furthermore, because private equity managers may have a specialized industry or niche that they invest in, they may hold concentrated positions that are not well-diversified—this presents a greater opportunity for significant loss. While a manager of publicly traded equity may hold 50 securities, some Private Equity managers will make less than 10 investments.

These private equity investments are typically partnerships, the investment manager being the General Partner and the pension fund investors being the Limited Partners. At the time of the investment (commitment) there are no investments made yet and the manager begins the process of looking for companies in which to invest. The investor has to rely on his own due diligence and the information pro-

vided by the General Partner to provide some confidence that the General Partner will do well. The need to perform proper due diligence is further heightened by one of the unique aspects of Private Equity—contractual agreements that lock up investor capital for more than a decade after the initial commitment. Our clients typically meet four times a year to conduct all of the business of the pension fund. They have no capacity and no investment staff to perform that due diligence. Most often they look to an investment consultant to provide due diligence for them.

Our process examines the private equity manager's: Form ADV (if it is registered with the SEC); insurance; audited financial statements, valuation procedures; third-party service providers; offering memorandum, and marketing materials; personnel; biographies of key employees; client references; complete historical returns for all prior funds; and a history of all limited partnership investments, total capital managed and strategy for all prior products. We require this information to proceed; however the General Partners are not required to provide it. If they refuse, we move on to another candidate. The General Partner moves on to another investor who may not demand these disclosures. The best General Partners provide all that is asked of them and more. The worst General Partners rely on slick presentations without appropriate disclosure.

The same can be said about disclosures after the pension fund has become an investor. We require quarterly detailed reporting on each investment including asset values, capital flows, and business plans. Of the General Partner, we continue to require reporting on their investment strategies, current market conditions and organizational issues. On an annual basis we collect and review Form ADVs where possible, insurance, audited financial statements and valuation procedures. Again all of this is a requirement we place on any partnership we recommend to our clients. Where this is not demanded by the investor it may not be provided because it is not required by law.

Our preference is for our clients to use private equity fund of funds instead of individual private equity funds. The fund of funds structure provides diversification of strategy, geography and industry. The fund of funds manager brings expertise, access, oversight and resources to the investment process and bears full responsibility for the evaluation, selection and timing of all investments in the fund. A good fund of funds manager demands all of the disclosures we listed and also has a good track record of discovering successful partnerships.

We believe this due diligence structure and the use of fund of funds are very effective tools for Taft-Hartley trustees. However requiring General Partners to provide these disclosures would ensure that all investors have the information they need to make intelligent, informed decisions.

Hedge Funds

There are over 9,000 hedge funds available to pension fund investors. They cover a multitude of strategies and approaches: Long/Short Equity, Merger Arbitrage, Relative Value, Distressed Debt, Fixed Income Arbitrage, Global Macro, CTA's and the list goes on. While the traditional manager invests in a stock or a bond in a long position, the hedge fund manager will also take that long position and then hedge it with a short position (short sale). This is done with publicly traded stocks, domestic and foreign, currencies, commodities, and bonds to name a few. These are some of the most sophisticated strategies executed in the industry. Consequently, it requires equally sophisticated supervision. That is why we prefer Funds of Hedge Funds for our clients. These are typically partnerships or LLC's that select a group of hedge funds and move in and out of them over time. The investor then owns shares of 30 to 50 hedge funds in a diversified portfolio rather than just a few they could select on their own. As a result, we focus on analyzing and monitoring the Funds of Hedge Funds.

We have developed a list of best practices for Funds of Hedge Funds. Generally, we will not recommend a fund of hedge funds that does not adhere to the majority of these best practices. We also expect the Fund of Hedge Funds managers to follow certain best practices in its due diligence and monitoring of underlying hedge funds.

Our best practices are divided into four categories of risk at the fund of hedge funds and underlying hedge fund level—people, investment, operational and business.

For people risk, we want a fund of hedge funds to provide client references and underlying manager references. We expect the underlying hedge funds to provide client references and to agree to background checks on their key investment and operations staff to the fund of hedge funds manager.

For investment risk, we want fund of hedge funds to agree to be an ERISA fiduciary, to provide the number of underlying funds and to report fund and client performance on a monthly and quarterly basis and aggregate strategy exposures on a

quarterly basis. We expect the underlying hedge funds to provide the number of their underlying positions and to report on at least a quarterly basis to the fund of hedge funds. We want both fund of hedge funds and hedge funds to provide: monthly returns; strategy and geographic allocations; and portfolio terms for liquidity and fees.

For operational risk, we want both fund of hedge funds and hedge funds to hire third party firms to manage custody, audit and administration responsibilities.

For business risk, we want both fund of hedge funds and hedge funds to provide general firm information regarding their inception, assets under management and number of accounts for both institutions and non-institutions. We also want them to provide general fund information regarding inception, assets under management (strategy and fund level), number of accounts and minimum investment amount.

Let me make it clear that these are the best practices we believe are appropriate and that we follow. They are not required in the law or in regulation.

Finally, we believe SEC registration should be required for all hedge funds and Funds of Hedge Funds, and thus we welcome Congress' passage of the Financial Reform Bill requiring registration of those funds with $150 million or more under management as an important step towards that goal.

Conclusion

The investment environment that Taft-Hartley Fund trustees face today is exponentially more complex than it was when I joined this industry three decades ago. It is difficult enough to expect trustees to understand the many investment strategies, but without full and complete disclosure by the investment community, it is nearly impossible for these trustees to do their job in protecting the retirement security of millions of American workers. From the professional advisor and fiduciary's perspective, I know requiring these disclosures would certainly help us do a better job of scrutinizing these investments.

I have also provided the Committee with our list of best practices for Private Equity and Hedge Fund investing as well as background documents on them and model principles and valuation procedures. They can be viewed at *http://www.marcoconsulting.com/cexhibits.html.*

I welcome any questions you may have.

Chairman ANDREWS. Thank you, Mr. Marco.

We would like to thank each of our witnesses for their preparation and excellent presentations this morning. We will now get to the questions from the Members.

Mr. Hutcheson, let's assume that I am a fiduciary of a defined benefit plan, and I am thinking about making an investment with my fellow trustees in a private equity fund that buys bad debt. The business principle of the private equity fund is that they think that people have undervalued this bad debt, that it is worth more than they were able to buy it for, and they are going to make a profit off of that.

Let me just walk through some of the resources available now for me to help make the decision as to whether or not that is a good or bad decision for the people to whom I have a fiduciary duty.

First of all, I assume that, on the basic level, if someone were stealing from that fund, that a competent accountant would find that; is that correct?

Mr. HUTCHESON. Most of the time, embezzlement would be discovered.

Chairman ANDREWS. Okay. Now, let's get beyond that to the more common sort of problem. When I look at the financial statement of this private equity fund, it is going to list on it assets of the debts owned by, right? The debts owned by the private equity fund are going to be listed as assets.

Who would do the valuation of those assets on that financial statement?

Mr. HUTCHESON. Well, there should be an independent audit performed of the fund, and there could be depending on the nature, where the debt came from. If the debt is from publicly traded companies, which it could be in the underlying private equity fund, you know, there should be a Sarbanes-Oxley——

Chairman ANDREWS. Let's assume it is bad real estate loans that the fund has bought from banks.

Mr. HUTCHESON. Well, the fund will hire an auditor—they call them internal auditors—to perform an audit and to put together the financial statement. We may not know what the probability is——

Chairman ANDREWS. Would we know—and I don't ask this as an accusatory question—if the auditor who did that audit, if it was the first time he or she had ever evaluated bad debt, would we know that?

Mr. HUTCHESON. No. No, you would not know that.

Chairman ANDREWS. If they had done it a thousand times, would we know that?

Mr. HUTCHESON. No.

Chairman ANDREWS. Yeah. As my friend suggests, if we asked—either you or Mr. Marco could answer this question—is that the type of information that would typically be made available if you asked for it?

Mr. HUTCHESON. If it occurs to the fiduciary to ask that question, which it should, they might share that with you. But that is a question that most fiduciaries wouldn't—it wouldn't occur to them to ask that question.

Chairman ANDREWS. What other documents might the fiduciary rely upon to determine whether to buy into that fund, besides the audited financial statement?

Mr. HUTCHESON. Well, drilling down a little bit in greater detail, the probability that the debts are actually going to be paid off, and why they think that. There needs to be some type of risk measurement tied to each one of the debt obligations, so they are understanding what the nature of the debt is, what the payment terms are, what the interest rates are. There is a large variety of things that go into investigating such a portfolio.

Chairman ANDREWS. Mr. Marco, in your work both acting as a fiduciary and advising fiduciaries, if you were presented with the hypothetical that I gave, what kind of due diligence would you perform in order to either make the decision or give advice about making the decision about that bad debt fund?

Mr. MARCO. The first step is before it starts when you evaluate whether you want to hire that investment manager to manage those assets. The due diligence requires, what is the process that you use to price the securities? Is there a methodology? Are there outside independent auditors? Are you applying FASB standards? All of these are questions you have to ask before you start the investment.

And if the answers are to your satisfaction, if they are complete, then afterwards it is asking the question when the assets are—checking to make sure they are continuing to follow their practices.

But it is the first step, requiring those things. And those are the things I described as best practices. That is what a good firm would

do. And if they are doing it, then that is fine. My view is that it ought to be required. It ought not to be just someone saying—because, again, my argument is that if we follow those and we recommend or select those funds that do that kind of appropriate due diligence, we are comfortable. But those that don't, that we don't recommend or don't use, they move on to the next investor and they get their money because they didn't ask the question, they didn't pursue it.

It is much more satisfactory—if they are required to provide it right up front, then you will know. Because once the investment is made, once you have given the money to the investment manager and have that, you own it; now it is a problem you have to deal with. So you avoid it up front if you have the right procedure.

Chairman ANDREWS. Mr. Chambers, one of the problems you noted in your testimony was about the date of the GAO report we are talking about this morning. And in fairness to GAO, obviously we haven't asked them to do anything since that time. They were asked at that time to issue their report.

And I would want the record to show that, yeah, I think that before any decisions could be made based on that report, it would need to be updated rather considerably, given what has happened since the report was written.

If we were to look at areas of inquiry that we think the GAO should do to follow up on the work it did in 2008, what kinds of questions do you think that we should ask them to look at?

Mr. CHAMBERS. Well, I think, to some extent, they have updated their report. And I think that the result of the update of their report is that, at least as I have glanced through it last night, it had the—the recommendations and the findings had not changed materially since the report in 2008.

I think that what they were doing is they were looking at, again, process. They are not suggesting regulation, they are not suggesting legislation. They are looking at process. They are focusing on perhaps the Department of Labor coming out with guidance, rather than regulation, on what types of best practices are out there.

What I would suggest to Mr. Marco, in connection with his last response, is what he perceives to be a best practice in conjunction with a particular type of investment fund, it is going to be very different, perhaps, than what Mr. Hutcheson's best practice would be——

Chairman ANDREWS. Or yours.

Mr. CHAMBERS [continuing]. Or mine, because, of course, I don't have any. I am just a lawyer.

But I do think that the best practices are going to be very complicated to create a definite, finite group of best practices, because it is going to differ from investment to investment. Some of them, of course, will overlap.

Chairman ANDREWS. Ms. Bovbjerg, what—and this will be my last question—what do you think the logical next series of questions we might ask would be that you could build on the work that you have done?

Ms. BOVBJERG. I think it would be really useful to know what is going on in the small plan universe, and that is a much harder thing to uncover.

The concern that we had in doing this report, when we talked with representatives of large plans, they had a strategy and they understood what they needed to do and talked about the challenges and how they were dealing with them—very competent people who had thought about this a great deal.

What we see is an increase in plans of the large and medium sizes going into hedge funds and private equity. What that suggests is, likely, smaller plans will follow. And I don't mean this in a pejorative way, but there is sort of a herd mentality among plan investors. They don't want to be the outlier, necessarily. And you could imagine a smaller plan coming to the conclusion that they are not being a very good fiduciary and they are not getting the returns that they should be getting because they are not doing this, too. And they really may not be capable of providing the kind of oversight that is needed. So that was a concern we had.

And the work we did in the last couple of weeks, looking forward to this hearing, looking at the data, suggested that the trend continues. And work we have under way in another way that touches on this doesn't, in any way, suggest that things are materially different.

Chairman ANDREWS. I appreciate that.

I thank each of you.

And I would turn to Dr. Price for his questions.

Dr. PRICE. Thank you, Mr. Chairman.

I want to pick up where that discussion was leaving off.

Mr. Marco, the GAO report talks about some States that had limited small plans to investment categories, small plans under $250 million, for example, unable to invest in hedge funds or private equity at a State level.

Is there merit to considering that at the Federal level?

Mr. MARCO. I do think there is some merit in that.

The issue is this: Very small plans, it is a question of if they have the wherewithal to hire the professionals to help them do the work. Small plans, almost by definition, don't have internal investment staff. So they don't have people, but they can go outside and hire investment consulting firms to that work for them.

Very small plans can't afford to do that, so they are left, then, with individuals who may not be investment professionals but fiduciaries of these plans to go out and make decisions on very complex information, as I said, where disclosure is not required, and even if it was, their level of handling it can be very difficult.

Dr. PRICE. Mr. Hutcheson, do you agree with that, that there is merit to having the Federal Government consider limiting what small plans can do?

Mr. HUTCHESON. I agree with Chairman Andrews that the Federal Government probably should not go there, with respect to limiting.

I think that the—Mr. Chambers said that perhaps some guidance from the government on what would be required for alternative investments would be appropriate. In the current small-plan world, we have investment fiduciaries who get paid a percentage

of assets, so there is a small percentage that is paid off the top that can be easily liquidated and paid to an investment advisor. In the small-plan world, it becomes difficult to have an investment advisor involved to monitor because you can't just liquidate the alternative investment to pay a fee. The small plan sponsor has to pay it out of their own pocket. And so it becomes problematic to, number one, get expertise in monitoring and evaluating.

However, I don't think that they should be limited. I think that fiduciaries simply need to understand that the burden, the due diligence burden and the monitoring burden, is significant and it requires true expertise.

Dr. PRICE. Ms. Bovbjerg, you commented in response to the chairman's question about what you might want to consider for a new report. Given the recent passage of the reg reform bill and the regulations that will certainly be forthcoming from the SEC and elsewhere, would it not be wise for Congress and the Department of Labor to wait until we see what other arms of the Federal Government are going to do and require before issuing any recommendations?

Ms. BOVBJERG. Well, we have never called for a requirement that would limit the types of investments.

Dr. PRICE. No, I am just talking in, kind of, a different umbrella. Just in terms of your report—the chairman asked you about your report. Would it not be appropriate for us to wait until we see what the SEC and others are doing in response to the reg reform bill?

Ms. BOVBJERG. It is our hope that Labor and SEC will work together as they consider these things. There is always that difficulty of who is the investor. I mean, SEC is protecting investors; Labor is protecting plan participants and sponsors.

We still believe that the Department of Labor should get some guidance up there. In fact, I think that what Mr. Chambers said about guidance that is available elsewhere could certainly help them decide what to put on their Web site. It shouldn't be that hard.

Dr. PRICE. Mr. Chambers, I would like to follow up with you on the concerns about limiting investments and your thoughts on Congress or the Federal Government, through a rule or regulation, limiting the ability for funds to invest.

Mr. CHAMBERS. Well, I would point out first that it seems that Mr. Marco probably just precluded his own defined benefit plan, if he has one, from investing in alternative investments, from what he was saying, because I suspect it would not have, at least in that example, $250 million.

And that is the point. It seems to me that there needs to be individual choice that is to be exercised by fiduciaries. We have a strategy for fiduciary rules that has been in existence for quite some time. It continues to get tweaked periodically through litigation and through court decisions.

But the reality is that there needs to be choice. And I think that it is incumbent upon the Department of Labor to provide guidance so that people understand what they are getting into if they decide to embark on an investment regimen that includes these types of investments.

I don't see that there is any basis whatsoever for additional regulation or legislation in this field, particularly as you were just asking, I think, Ms. Bovbjerg about the fact that we are going to have a slew of information that is coming out in conjunction with the Dodd-Frank bill.

And just one other point about that, which is that—and I don't pretend to be a guru in conjunction with the Dodd-Frank bill—but I would point out that, as I understand the registration requirements in that bill, it is the advisor, not the fund, that would be registered. There would certainly be fund information that would need to be provided by those registered advisors, as well as perhaps, if the SEC finds the need, other advisors that are not registered.

But the most important thing is that that information is supposed to be held confidential. And it seems to me that Congress has just acted—well, shortly, when the ink dries, if it is ever applied—has acted in a fashion that says, "We think that imparting this information is very important, but it is to be imparted to the government for purposes of determining risk. We understand that there is proprietary information that we are probably going to be requesting. And if that proprietary information is then handed out to the general public, we, Congress, do not believe that that is the best way to handle it."

And I think what Mr. Marco and, to some extent, Mr. Hutcheson are suggesting in their written testimony is that there should be a requirement that a lot of that information, which is proprietary, which is private, in fact, should be disseminated to the general public. And that is contrary to what Congress just decided.

Dr. PRICE. Thank you.

Thank you, Mr. Chairman.

Chairman ANDREWS. The chair recognizes Mr. Kildee for 5 minutes.

Mr. KILDEE. Thank you, Mr. Chairman.

Mr. Chairman, I have served on this subcommittee now for 34 years. It was called a task force at the beginning, with Frank Thompson as the chairman, and then the task force was folded into the committee. And Frank used to say at that time that there was only one person in Washington who understood ERISA, and that was Phyllis Borzi. And I think probably the number has grown since then. But it was a very complex bill, and we were trying to address a problem that existed out there.

I want to commend you, Mr. Chairman. I have served with a lot of chairmen, and I have found none better than you, both in head and heart, because you really believe in the importance of this bill.

I would like to ask a question, address it to Ms. Bovbjerg, and if the others want to answer. It is a very generic question: If any, what is the most significant change or changes we could make to help improve accounting transparency for pensions?

Ms. BOVBJERG. I am actually sitting before the subcommittee and thinking about fees. It is difficult for me to think about disclosure and pensions without thinking about 401(k) fees. I know that is not really your question.

When I think about what fiduciaries need to deal with, it is a very difficult job, and I salute you. I think they need all the information they can get. That said, I think it is important to try to bal-

ance the costs versus the benefits of getting that information. So if there were to be, you know, more audited information, you would have to think about what it would take to get that.

I just did want to point out, though, that in our work, the plans that we contacted—so these are medium and large plans—virtually all dealt only with registered advisors for their investments in hedge funds and private equity.

Mr. KILDEE. Anyone else want to comment?

Mr. HUTCHESON. Yes. Thank you very much.

In my written testimony, I think there are four practical ways to enhance accounting transparency. The first one that I mentioned is requiring audit of internal controls. And that is normally associated with the Sarbanes auditing.

And, you know, early on, that was a significant burden to publicly traded companies. But, you know, it has been 10 years since—we are approaching 10 years since Sarbanes came into effect. And it is a lot easier these days to get an audit of internal controls. So, for example, a hedge fund could obtain a Sarbanes-like audit of internal controls without it become a burden to the hedge fund.

And I do agree with Mr. Chambers. You know, the allure of the private equity and hedge funds is that there are some proprietary methodologies and knowledge and systems that these managers use. And if that got into the public, it would kind of render their business model—it would injure it. And so I think that there is a way to apply the audit of the internal controls without it becoming public, like it is with publicly traded companies.

So, you know, I am not opposed at all to that line of thinking. That is the whole idea of having private equity and hedge funds available, is their proprietary methods.

The second one is the financial statements. They are not easy to understand. We need a summary in plain English that says, "This is what this financial statement means."

Enterprise risk management skills, that should be the hallmark of every hedge fund manager and private equity fund manager. These are the risk-management skills that we are trying to deploy here. If we can't avoid it, we need to reduce it. If we can't reduce it, we need to spread it out and diversify it, or perhaps accept it. But there needs to be skills in managing that.

And the last one is the fair valuation standards. The problem, currently, with the fair valuation standards and FASB is trying to bring those into a more consolidated, tight definition. But hedge fund managers and private equity managers are able to give the CPA who is performing the audit internally and preparing the financial statements variables, which are called unobservable inputs.

These are the inputs that we believe will make sense to an investor and give them the information they want to invest in this fund, and then the auditor assigns the value of the fund. Well, the problem with that is there could be three or four different unobservable inputs that could materially change the value. And so those unobservable inputs—they are unobservable, hence they are not transparent to fiduciaries who need to make the decisions. We need to know what those variables are. In other words, if input A is used and the fair market value is X, what would the impact be if we use

input B or C? How would that change the fair market value? I think we need to know those things.

Mr. KILDEE. Thank you.

Thank you very much, Mr. Chairman.

Chairman ANDREWS. I thank my friend for the very nice compliment as well. The chair recognizes the ranking member of the full committee, the organic farmer from Minnesota, Mr. Kline.

Mr. KLINE. Thank you, Mr. Chairman, and thank you to the witnesses. And, Mr. Chairman, I want to congratulate you on yet again finding a witness from Cornell Law School, thus strengthening the bonds of the Cornell Law School Alumni Association.

Chairman ANDREWS. I think she is actually not from the law school. We are diversifying our witness list. She is from the master's program. This is entirely different.

Mr. KLINE. This is entirely different. I take it back. I take my congratulations back.

I want to sort of pick up on some of the things that Mr. Price was asking about and the chairman addressed, and that was the issue of the timing of the 2008 GAO report, the subsequent additions and modifications that Mr. Chambers was reading last night, and the comments that a couple of you have made about the financial reg bill, the Dodd-Frank bill. It is my understanding that we are in for a blizzard of

rulemakings—some hundreds and hundreds from the health care bill that still aren't done yet, and I have been told over 300 from the Dodd-Frank bill.

And so the sort of general question is—and it is to anybody who—Mr. Chambers said he is not the guru of this legislation—but anybody who has some idea of what the impact will be in this very area. I mean we have been calling for the Department of Labor to put up guidance and not regulations, as I understand the discussion here. But, nevertheless, it seems to me, and that is what I am asking you, that there could be some serious changes that come into effect when this rulemaking process moves toward its conclusion, and it might affect guidance and regulation and everything else.

So anybody, guru or not, who has an opinion on this, I would like to hear from you.

Mr. MARCO. I am not sure what rules will be covered but I think the issue of disclosure—and I would like to differ with some of the comments that were made earlier—I think the idea of saying to an investor, "Invest in this fund of hedge funds. I can't tell you what I am doing and I can't tell you what I am holding, because that is proprietary. Just trust me. But you invest in this and that is fine. I am not going to tell you, and I can't tell you." This is nonsense. No one would do that in their right mind. There has to be some kind of supervision of what it is you are buying, what it is you are investing in. For us, it is not a problem. As the fiduciary for the clients that we serve, we demand that disclosure, and we get it. We also sign——

Mr. KLINE. If I could interrupt, I take your point. But what I am getting at is do we think Dodd-Frank, with its hundreds of new rules and regulations, is going to affect any of your practices or any of the processes that are underway now that might affect whatever

guidance the Department of Labor would put out? And so that is what I am looking at.

Mr. Chambers.

Mr. CHAMBERS. There is a tremendous amount of discretion that has been afforded to the SEC under the bill, as I understand it. And, therefore, I think it is somewhat difficult to say, well, clearly we are going to have guidance on this field or we are going to have—we are going to recognize a requirement to provide this sort of information, but I do think that some of the things that will happen as a result of this in connection with hedge funds—and it is not even sure to the extent to which they are going to cover private equity—but with regard to hedge funds is that the larger hedge funds, of course, will be providing a pretty significant amount of information, I expect, to the government. The government will be assessing that in conjunction with in particular the risk element of what it is that those organizations are doing, as well as working with outside accountants and things like that.

I personally believe that because a number of the exemptions from registration that have existed in the past are being changed or eliminated, I think a lot of this is going to move offshore. I think that what you are going to find is that, under this bill, there are a number of organizations that provide access to investments like this which are going to try to avoid the registration and other things. They are going to limit the amount of assets they have under management and they are going to move offshore. They are going to remain small.

I guess the one point that I would make tough to Mr. Marco is that I think it is disingenuous to expect that there is going to be a tremendous or that there could be a tremendous amount of information regarding these private companies to be disseminated and to be updated and to have those organizations be able basically to afford to provide that kind of information.

Finally, if I may, finally, there is a very simple response: Don't invest in anything where you feel that there is not sufficient information. This is the tail wagging the dog. Don't invest in something if you feel that the information is incorrect or that it is insufficient. That is what we do with regard to investments in things where there is public disclosure. Don't invest. That is what they are hiring you for.

Mr. KLINE. Thank you. I see the red light is on. I think that confirmed my suspicion that we have got a lot of rules coming and we don't know what they are going to do. So thank you very much.

I yield back, Mr. Chairman.

Chairman ANDREWS. The gentlelady from Ohio, Ms. Fudge, is recognized for 5 minutes.

Ms. FUDGE. Thank you all for being here. My first question is initially directed to Mr. Chambers and anyone else is free to answer. I just want to be clear or ask if you are suggesting or if you believe that setting fiduciary standards for hedge fund managers will impede their ability to manage their funds.

Mr. CHAMBERS. I may have missed the middle part of your question. If we create responsibilities for hedge fund managers?

Ms. FUDGE. If we create standards, which is what we are talking about to some degree, do you believe that that is an impediment for them to manage their funds, just by creating the standard?

Mr. CHAMBERS. I think in large part, yes.

Ms. FUDGE. Why is that?

Mr. CHAMBERS. As I have indicated, I think that a lot of the information that could be requested and disseminated to the public rather than kept at the government level, as it would be under the Dodd-Frank bill, is information that could be proprietary and it therefore could have an adverse impact on how they run their fund.

Secondly, I think that depending upon how much information is required, as anyone who has ever worked with a public company or who has worked with a registered investment kind of arrangement understands, there is a significant cost that is going to be associated with creating that kind of information and keeping it updated. Those are just two out of many reasons why.

Ms. FUDGE. So do you believe that there should not be standards for hedge fund managers?

Mr. CHAMBERS. I think that hedge fund managers, like people who operate and own any private business, do have a certain sense of standards that they need to owe to

shareholders, that they need to owe to their employees, and we have existing laws that provide those standards. What I am suggesting here is that with regard to—and that is with regard to any organization that is not publicly—where there is no public market. If an organization is going to have a public market, if it is going to hold it itself out as being an investment-grade opportunity for the general public, then yes, there are additional standards that we as a government have imposed over the years. Those standards have never in the past been extended to private industry that is not out there seeking public investment.

Ms. FUDGE. My second question, and to any of the members of the panel, but particularly for Mr. Hutcheson. Without additional disclosure, do pension plan managers understand the risks involved in investing in hedge funds and private equity funds? And I guess probably maybe put a different way, is it useful information or is it just more information?

Mr. HUTCHESON. Excellent question. To clarify this discussion about whether proprietary information should be shared or whether the risks are understood, I think the key to all of this, and I think it is very, very important, a fiduciary has to know what is going on in the fund. So to clarify my prior statement, I am not suggesting that alternative investments need to have all their proprietary information shared with the public. Does it need to be shared with the fiduciaries? Absolutely. There is no question about it.

I think Mr. Chambers isn't suggesting that information be withheld from fiduciaries. Otherwise, they can't make a good decision.

But the thing that is more important, the hallmark of any investment, is the concept of expected return. A lot of people get nervous when they hear that, but unless an investor, like a trustee of a pension plan, can expect a favorable outcome from the investment of their capital over a specific period of time or a long time horizon, they can't really determine what the merits are of that particular

investment. And so we talk about all the time: "what are the risks, what are the risks, what are the risks?" Well, that is fine, but I need to know what the expected outcome or expected return, which is really, truly the hallmark of investing. If you can't expect a favorable outcome, the markets, whether they be private or public, will come to a screeching halt because the flow of capital will stop.

I mean, are you going to give your capital to somebody if you can't expect something favorable to happen? No. You won't do it. Nobody else will either. So the real issue is what are the expected returns. And then, when you evaluate the expected returns, you have to balance that out with what are the expected risks. And that requires a lot of information.

The four elements that I talked about earlier I believe are the foundation for disclosing what a fiduciary needs to know and understand about expected return and expected risks. And so to tie all this together, at the end of the day it is the fiduciary who has to make the decision. I don't think the government needs to make those decisions. The fiduciary has to make the decision. But they have to be informed and they have to understand before they can make that decision. That requires knowledge and disclosure. And so I envision that taking place between a hedge fund manager and the fiduciary in an office. They are talking about it. Things are disclosed to the fiduciary and the fiduciary can consider it, but I am not necessarily in favor of broad distribution of information. If the fiduciary wants it, they can get it. And if they can't get it, move on.

Ms. FUDGE. Thank you very much, Mr. Chairman.

Chairman ANDREWS. Thank you. The gentleman from Oregon, Mr. Wu, if he chooses to be recognized.

Very well.

We would like to thank the witnesses and the members of the committee for their diligence today, and I would return to the gentleman from Georgia for any concluding remarks he would like to offer.

Dr. PRICE. Thank you, Mr. Chairman. I think this has been helpful. The information that has been provided to the committee I think will allow us to hopefully step back and take a deep breath, wait on the SEC and, as my senior member Mr. Kline said, the blizzard of regulations and rules that will be forthcoming and see where we are at that point. But I think this has been helpful. Transparency is important. There is no doubt about it. However, limiting individuals' opportunities and options in terms of investing the way that they believe to be most appropriate for themselves is, I think, something that is anathema to our system. If we move down that road, then I fear that we continue to move down the road that changes the very fabric of our Nation. And I am hopeful that we do not continue in that vein.

So, Mr. Chairman, I appreciate the opportunity. I would ask unanimous consent that included in this hearing record be an article from the Wall Street Journal earlier this week, Congress Overhauls Your Portfolio.

Chairman ANDREWS. Without objection.

[The information follows:]

[From the *Wall Street Journal*]

Congress Overhauls Your Portfolio

Hidden in Washington's Historic Finance Bill Are Major New Rules Affecting Nearly Every Corner of the Investing World

By Eleanor Laise

With all the talk of "systemic risk" and "too big to fail," small investors might assume that the landmark Dodd-Frank financial overhaul bill has little bearing on their portfolios.

They would be wrong.

Buried in the bill's 800-odd pages are the most sweeping regulatory changes for ordinary investors in decades, affecting everything from mutual funds and retirement plans to single-stock investments and other holdings.

The legislation has the potential to make brokers more accountable to their clients, shine light on hedge funds and improve the transparency of the complex derivatives on which many mutual funds and pension plans rely to hedge their risks.

Several provisions promise to give investors a louder voice in policy-making circles and corporate boardrooms. Within the Securities and Exchange Commission, for example, the bill sets up an Office of the Investor Advocate designed specifically to assist retail investors, and the Investor Advisory Committee, which focuses on initiatives to protect investors' interest. And the bill gives the SEC authority to make it easier for shareholders to nominate directors for corporate boards.

Taken as a whole, the legislation not only "lays the groundwork for significant improvements" in investor protection and disclosure, but also gives investors "a greater voice in the policies that affect their interests," says Barbara Roper, director of investor protection at the Consumer Federation of America.

Yet despite its hefty dose of investor-protection provisions, the legislation isn't a home run for small investors, analysts and investor advocates say. So-called stable-value funds, popular investments among the most conservative 401(k) participants because they are designed to deliver smooth, steady returns, are left in limbo, awaiting regulatory decisions that could affect their costs and availability in retirement plans.

Likewise, while investor advocates had pushed aggressively for the SEC to oversee "equity-indexed annuities," these complex products escaped the agency's purview.

What's more, the bill's full effects on small investors likely won't be known for some time. Many provisions call for regulators merely to study certain issues or give them the power, but not the obligation, to make certain rule changes.

But in the meantime, investors can prepare for some significant changes in their mutual funds, hedge funds, retirement plans, brokerage accounts and single-stock holdings. Here are the important factors to watch:

Mutual Funds

Though mutual funds are barely mentioned in the Dodd-Frank bill, the legislation could affect everything from funds' bond and derivatives holdings to how these products are advertised to investors.

For bond funds, the bill creates some uncertainty and could even boost volatility in certain types of holdings, managers and analysts say. That is because it gives the Federal Deposit Insurance Corp., which can seize troubled financial institutions, leeway to pay investors holding identical bonds issued by that institution differing amounts. If investors aren't sure how they will be treated in such a scenario, they may demand higher yields, which means lower bond prices, or dump the bonds at the first sign of trouble, money managers say.

The provision "can have all sorts of unintended effects," says Bob Auwaerter, head of fixed income at mutual-fund firm Vanguard Group. If mutual funds are trying to sell bonds as the issuer tumbles toward default, the potential for unequal treatment of bondholders "will reduce liquidity and lower the price," Mr. Auwaerter says.

One little-noticed provision in the bill could be critical for mutual-fund investors prone to poor market-timing decisions. It calls for the Comptroller General to study mutual-fund advertising, including the use of past performance data, and recommend ways to improve investor safeguards. Academic research suggests that "short-term performance ads really do drive investor dollars, and unfortunately not in a good way," says Ryan Leggio, fund analyst at investment-research firm Morningstar Inc. "Those usually lead investors to the hot fund of the month or the year."

Retirement Plans

Stable-value funds, the most conservative investments in many 401(k) plans, are left in a regulatory gray zone.

These funds typically consist of a diversified bond portfolio and bank or insurance-company "wrap" contracts, which allow investors to trade in and out at a relatively steady value. As the bill was being hammered out, the stable-value industry lobbied hard to keep these wrap contracts from being categorized as "swaps," a type of derivative subject to a slew of new rules. Instead of making a final decision, lawmakers called for regulators to study the issue within 15 months.

A swap designation would make stable-value wrap contracts more complex to issue and more costly, stable-value experts say, ultimately dragging down 401(k) participants' returns. That outcome "would have an immediate and very troubling effect on 401(k) plans across the country," says Kent Mason, partner at Davis & Harman LLP and outside counsel to the American Benefits Council. The regulatory uncertainty itself could potentially make issuers more hesitant to offer the contracts, he says.

Stable-value contracts are in short supply already, since issuers became more reluctant to offer them in the wake of the financial crisis. But since demand for the contracts remains strong, fees for these wraps have increased significantly.

Hedge Funds and Other Private Investments

The Dodd-Frank legislation helps to push hedge funds out of the shadows.

Funds with more than $150 million in assets generally must register with the SEC as investment advisers. For registered firms, investors can get some basic information about their business activities, employees and disciplinary history through the public SEC website, adviserinfo.sec.gov.

Some investor advocates hope that, with more firms registering, regulators also will deliver a long-promised overhaul of registered advisers' required public disclosures. In a May speech, SEC Chairman Mary Schapiro said the Commission is preparing to require "a plain English narrative discussion of an adviser's conflicts, compensation, business activities and disciplinary history."

While many larger hedge funds already have registered with the SEC, the new requirement will likely boost operating costs for smaller funds not yet registered. Many of these funds are already struggling to raise money, and may consider closing down or raising fees they charge investors. "Clearly there is a group of managers who will never get off the ground," says Nathan Greene, a partner in the asset-management group at law firm Shearman & Sterling LLP.

The bill also raises the bar for individuals to qualify as "accredited investors," a basic threshold for buying private investments. These investors must now have $1 million excluding the value of their primary residence, whereas the old standard was simply a $1 million net worth.

Individual Stocks

The Dodd-Frank bill will likely give shareholders, including small investors and mutual funds, a louder voice in corporate boardrooms.

The bill confers authority on the SEC to allow shareholders access to corporate proxies to nominate directors. "Major shareholders with long-term interests in the company are going to be able to hold management accountable," the Consumer Federation's Ms. Roper says.

There isn't any guarantee, however, that larger shareholders will make much use of this perk. "I can't be bothered with trying to find the right people to put on the board," says Albert Meyer, co-manager of Mirzam Capital Appreciation Fund. "Personally I would sell a company's stock if I thought the board was inept."

Under the bill, shareholders also get a "say on pay," meaning a nonbinding vote on public companies' executive compensation. Such a vote "is an important component of monitoring executive compensation," says Jim Hamilton, an analyst at financial-information provider Wolters Kluwer. Though the vote is nonbinding, a "no" vote by shareholders would likely force management to respond in some way and can still have a beneficial effect, he says.

Derivatives

While many small investors avoid dabbling directly in derivatives, mutual funds, exchange-traded funds and pension plans use them extensively. Money managers, for example, use these complex financial contracts to boost exposure to particular market segments or hedge risks such as interest-rate and currency changes.

The bill should help cut risks in funds holding derivatives. It calls for many types of derivatives to be exchange-traded and "cleared," meaning trades are routed through a central clearinghouse that covers losses if a party to the trade blows up. It also requires many derivatives traders to post "margin," so they will have cash on hand to pay other parties if their bet goes awry.

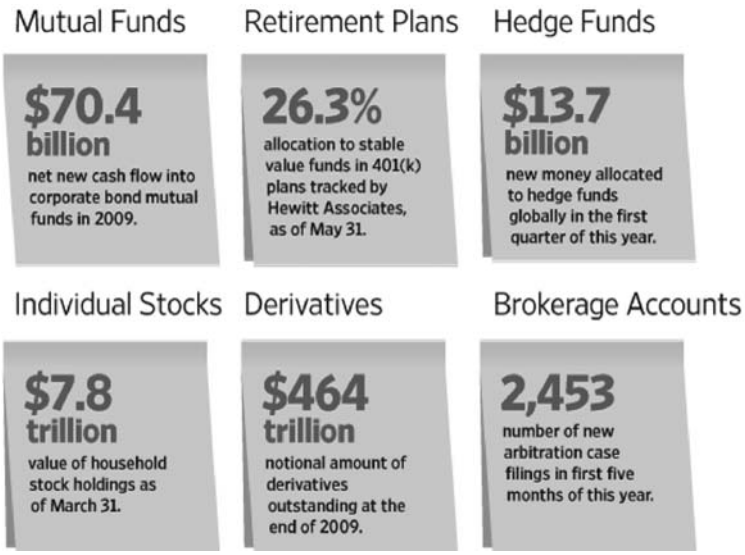
Funds, and their shareholders, may pay a price for such safeguards. While exchange trading should improve pricing, all the new rules also could boost some costs of derivatives trading, managers and analysts say.

The upshot: Since derivatives are here to stay in mutual funds, "portfolio managers will grin and bear it, and it will be some incremental drag on the overall performance" of funds, Mr. Greene says.

What's more, it is doubtful the new provisions would have prevented all the derivatives-related mutual-fund blow-ups of the financial crisis, analysts say. Oppenheimer Champion Income, a high-yield bond fund, dropped nearly 80% in 2008, partly because of derivatives tied to commercial mortgage-backed securities. Exchange trading won't stop such disasters.

Brokerage Accounts

The bill gives the SEC authority to impose the same standard of "fiduciary" duty on brokers that currently applies to investment advisers. That would mean that brokers must provide advice that is in clients' best interest, whereas currently they are required only to recommend investments that are suitable for customers.



The SEC must first study the issue and deliver a report to Congress. But given that Ms. Schapiro, the SEC chairman, has voiced support for such a measure, investor advocates are optimistic that regulators will follow through.

The bill also authorizes the SEC to limit or prohibit the mandatory predispute arbitration clauses that apply to many brokerage accounts. Such clauses force brokerage customers to take any disputes that might arise with their broker before arbitration panels, which critics claim often favor the brokerage industry, rather than taking their claims to court.

Since taking your broker to court can be costly and time-consuming, investor advocates say, the best outcome for investors would be to have access to both arbitration and the courts. "You need to give the party with the least power, the investor, the right to choose," the Consumer Federation's Ms. Roper says.

Gregory Zuckerman contributed to this article. Write to Eleanor Laise at eleanor.laise@wsj.com.

Dr. PRICE. Thank you.

Chairman ANDREWS. The gentleman from Oregon said he would like to ask a question. I am going to permit that. Frankly, Dr. Price, if you would like to follow up on that, you will have that opportunity before we close. The gentleman from Oregon is recognized for 5 minutes.

Mr. WU. Thank you very much, Mr. Chairman. I just have one question. This hearing is focused on transparency. Most of our Federal securities laws—most—are based on disclosure. There are some substantive constraints in Federal securities law and State blue sky laws are more based on substantive constraints. I would like to hear the witnesses talk just for a second about whether each of you feels that the disclosure and transparency mechanisms are, in and of themselves, completely adequate, or whether there is a significant role for some substantive constraints. I would view, for example, margin limits as one example. I am sort of remembering it as the uptick rule for certain types of sales, whether some substantive constraints are also necessary because it may be the case that transparency alone is not enough; that the market may not be fast enough and, quite frankly, there are some things that are so complex that even a very sophisticated investor may not be able to

understand exactly what is going on even when fully disclosed or certainly not in a sufficiently timely manner to react to market conditions.

I would like, to the extent that you all have any comments on that, I would be very interested in your comments.

Mr. MARCO. First, I would say that disclosure does so much of getting you along that path so that the investor knows what it is and how risky and how much leverage is going to be an investment. All of the things I have talked about today, to correct some of the other comments, are being done today. They are best practices of managers who are doing it. I am not suggesting inventing something new. There is an organization called Institution of Limited Partners Association with hundreds of members who have agreed to these best practices. So it is not like asking people to do something that is a burden—this is what the best investment firms do.

Now, to your point when they disclose and the investor can see the amount of risk taken, it will give people pause and perhaps choose not to be invested in one of these things. If they can get the information to know what it is they are doing, they may choose not to.

I think down the road there may be some room to say that there may be some limitations on the kind of things that these investment vehicles can do. I sort of suspect that the reason that the SEC hasn't done a lot in this area is because, to a large extent, they don't understand them. They don't have the staff of professionals that understand all the complex things that are going on within these hedge funds, and as they start to learn more, they may say, well, there is a limit to how much leverage we can do—someone could put on something. But, unfortunately, to deal with hedge funds is, by their nature, they are very complex and they are trading in very complex ways and leveraged, which makes them very risky, which says, first of all, the investors ought to know what the heck they are getting into when they purchase—when they use these investment managers to make these bets. But then, for someone to come in and say, okay, in doing these complex strategies, only 2 percent of this and 5 percent of that, gets to be pretty difficult. I am not exactly sure how—I am sure there are some areas that could be done, but I think you get much further down the road by saying, explain what it is you are doing, give detailed information to fiduciaries, not published in the public record, but to the supervising fiduciary to say, this is what we are doing, show us your position, show us your leverage, so we can understand what you are doing, gets you a long way to helping fiduciaries handle these kind of assets rather than have to set borders on the individuals.

Mr. WU. Just following up on that, there may be, in your view, some mechanisms which are so inherently risky that once understood by the SEC staff, that one may choose as a matter of public policy to take that mechanism out of the tool box because they are inherently too risky?

Mr. MARCO. That is possible.

Mr. HUTCHESON. If I may also just comment. One thing that comes to mind is naked short selling. Not only—I think that that

shouldn't exist within qualified retirement plans, number one, because of the risk that it creates not only for the plan but also as a systemic risk. Failed naked short sales create a systemic problem that affects other hedge funds, other pension plans.

So when you said is there something of substance that you would limit, I would say, if a plan is considering a hedge fund or some type of investment philosophy, I would personally ban naked short selling. I won't buy knowingly anything that has exposure to failed short sales or other systemic risks like that.

Mr. CHAMBERS. May I just take one moment? Congressman, I think that your question requires taking a step back because it is not just a matter of deciding what needs to be restricted, I think it is a question of weighing the rights of people who are putting together a particular type of investment and the rights of people who are thinking about investing in that investment. And as I mentioned earlier, and I think you were not here at the time, if you are going to be making public opportunities available, then I think, as a matter of public policy, yes, there is a lot of information that needs to be required. On the other hand, most, not all, but most of these private equity funds and certainly hedge funds are private arrangements. They are contracts between investors who want to find out as much as they can about those investments and the people who put the investments together, the managers or the advisers, who decide how much information they wish to provide and how much they do not. And I think that the weighing of this now is: Are you going to be taking what is now available only in conjunction or required only in conjunction with public investments, publicly traded investments, and are you going to be making some of that required for private industry? And that is an enormous step. And the question is, as I mentioned earlier, isn't the answer to this that someone is willing to give this amount of information, and if the person is not willing to make an investment based upon that information, they don't have to make the investment. Why is it that DB plan fiduciaries should have a right that perhaps is greater than investors who are investing for themselves or who are investing for college endowments. These are willing buyers and willing sellers, and I think that what you are asking is that we might be interested in making some of these disclosure requirements much further downstream than we have ever considered doing before.

Mr. WU. Well, there are some open—there are some transactions that folks might be openly going into that we banned for other reasons. We don't permit someone to sell themselves into slavery or to do a murder contract. Those are extreme examples, but in all the market or the transactions that you are talking about, whether in an open market or not, they have, by their nature, some impact on folks who are not parties.

Chairman ANDREWS. The gentleman's time has expired.

Dr. Price, if there is any closing.

I will, again, thank the witnesses and members of the committee.

When the discussion that Mr. Hutcheson theorized takes place in an office where a fiduciary for a defined benefit plan or the representative of fiduciaries is meeting with the representative of a hedge fund or private equity fund and discussing whether or not

to make an investment, obviously the people who have received the pension from that fund have a vital stake in that discussion. But there is also a silent partner in any one of those discussions, and one way or another it is the taxpayers of the United States because of the PBGC and the role the taxpayers, I think, ultimately have in standing behind the PBGC.

In my mind, this leads to one conclusion and then a series of questions. As I said at the outset of the hearing, I do not embrace the proposition that protecting the taxpayers requires precluding investment in these classes of assets. I think the opposite is true. I think that a fiduciary who diversifies is a more prudent fiduciary than one who doesn't. So I think making these classes of assets fully available to defined benefit plans ensured by the PBGC is entirely appropriate, and I would not favor anything that restricts that.

The series of questions that are raised though are: Do these decisions take place in a context of adequate or desirable transparency? Do the fiduciaries have access to comprehensive, relevant, real-time information to help them make these decisions. I don't know the answer to that question. I think that is a question that ought to be looked at.

To the extent that there is not; to the extent that there is not access to relevant, adequate, real-time information, what conditions might create the environment where that is the case?

Clearly, a pension fund with a robust balance sheet is in a market position to demand such access or not make the investment. And I do think that is the most powerful way to avoid this problem, the most powerful antiseptic to any toxin that might exist. The question becomes what, if any, steps are appropriate for us to take to create that environment. These steps range from perhaps simply making more education more available to more fiduciaries on a basis of education, ranging all the way from there to legal changes that would require such disclosures.

I find myself this morning in a position that is agnostic on that question. I think before one answers the question of whether the law should require more disclosure, we have to get to the issue as to whether disclosure is adequate or inadequate in the first place. I would hope that the committee would pursue that question, again not so that we might necessarily lead to a legislative proposal or a regulatory one, but so that we can assure that the best quality of transparency is available in every one of these transactions.

Sort of an implicit answer to Mr. Chambers' argument, which I think he makes very persuasively, the reason that that defined benefit plan trustee may have some right that is prior to some of the other investors that you mentioned in your last comments is that the taxpayers are underwriting that decision in a way they are not in at least some of the others that you mentioned. So there is a public interest here in trying to prevent yet another bailout, yet another financial disaster the taxpayers of this country would be called upon to address.

I think that the defined benefit system is a success, and I think the record will show that investments in alternative investments have been a success, by and large. I think that the last thing in the world that we want to do is micromanage fiduciary decision-

makers around this country. What we want to do is create an environment where those fiduciary decisionmakers have adequate access to adequate, relevant, real-time information so they may do their job and be held to the high standard to which the law holds them today.

You, ladies and gentlemen, have given us much food for thought. You have given us a lot of excellent information. I am sure that we will be calling upon you again as we deliberate on this and other issues.

Without any further ado, without objection, the Members will have 14 days to submit additional materials or questions for the hearing record.

Without objection, the hearing is adjourned.

[Additional submission of Mr. Kucinich follows:]

[From the *New York Times,* July 17, 2010]

A.I.G. to Pay $725 Million in Ohio Case

By MICHAEL POWELL and MARY WILLIAMS WALSH

The American International Group, once the nation's largest insurance group before it nearly collapsed in 2008, has agreed to pay $725 million to three Ohio pension funds to settle six-year-old claims of accounting fraud, stock manipulation and bid-rigging.

Taken together with earlier settlements, A.I.G. will ladle out more than $1 billion to Ohio investors, money that will go to firefighters, teachers, librarians and other pensioners. The state's attorney general, Richard Cordray, said Friday, that it was the 10th largest securities class-action settlement in United States history.

"No privileged few are entitled to play by different rules than the rest of us," Mr. Cordray said during a news conference. "Ohio is determined to send a strong message to the marketplace that companies who don't play by the rules will pay a steep price."

A.I.G. disclosed the terms of the settlement in a filing with the Securities and Exchange Commission.

How A.I.G. will pay for this settlement is an open question. It has agreed to a two-step payment, in no small part to give it time to figure out how to raise the money.

Executives are well aware that taxpayers and legislators would cry foul if it paid the lawsuit with any portion of the $22 billion in federal rescue money still available from the United States Treasury.

Instead, the company intends to pay $175 million within 10 days of court approval of its settlement. It plans to raise $550 million through a stock offering in the spring of 2011. That prospect struck some market analysts as a long shot.

"There's still a lot of question marks hanging over A.I.G.," said Chris Whalen, a co-founder of Institutional Risk Analytics, a research firm. "How would you write a prospectus for it?

"The document," he said, "would be quite appalling when it described the risks."

A.I.G.'s former chief executive, Maurice R. Greenberg, and other executives agreed to pay $115 million in an earlier settlement with Ohio, which filed its lawsuit in 2004.

State attorneys general often have proved more aggressive than federal regulators in going after financial houses in the wake of the 2008 crisis. And A.I.G. could face new legal headaches. For instance New York's attorney general, Andrew M. Cuomo, has stepped up his investigation of the company in the last few weeks, according to a person with direct knowledge of the case.

The Ohio settlement allows "A.I.G. to continue to focus its efforts on paying back taxpayers and restoring the value of our franchise," Mark Herr, a company spokesman, said in a news release.

The Ohio case was filed on behalf of pension funds in the state that had suffered significant losses in their holdings of A.I.G. when its share price plummeted after it restated results for years before 2004. Those restatements followed an investigation by Eliot L. Spitzer, Mr. Cuomo's predecessor, into accounting irregularities at the company and the subsequent resignation of Mr. Greenberg.

But the company faces a long and uncertain road, say Wall Street analysts.

Its stock, after adjusting for a reverse split, once traded at $1,446.80 a share; it stands now at $35.64.

A.I.G. has become the definition of turmoil. Its chairman resigned this week after a fierce feud with the chief executive, who has referred dismissively to "all those crazies down in Washington."

Those crazies presumably include the federal government, which over the last two years gave A.I.G. the largest bailout in United States history, making $182 billion available to the company.

And the company's proposed stock offering next year is rife with uncertainties. Such an offering would by definition dilute the value of the government's holdings.

A.I.G. has struggled of late to sell off subsidiaries to repay the Federal Reserve Bank of New York. This year the company failed in its attempts to turn its Asian life insurance subsidiary over to Prudential of Britain. This week the company's directors voted to proceed with an initial public offering of the same subsidiary, with the proceeds intended for the Federal Reserve.

Should the company fail to raise the $550 million, Ohio has the right to resume its litigation.

The fall of the world's largest insurance company began in the autumn of 2008, when a sudden downgrade in its credit worthiness set off something like a bank run. It turned out that the company had sold questionable derivatives that were used to prop up the portfolios of other financial institutions.

Federal officials moved quickly to bail out the company, fearing that if A.I.G. toppled, dozens of financial institutions would quickly fall as well. Havoc seemed in the offing.

Federal investigators have since examined many aspects of the company's behavior, even convening a grand jury in New York. But they have never brought charges against the company or its top officials.

"The states are too often the only ones to watch out for this misconduct," Mr. Cordray said Friday. "For years, people have been asleep at the switch."

[Additional submission of Dr. Price follows:]

Prepared Statement of Richard H. Baker, President and Chief Executive Officer, Managed Funds Association

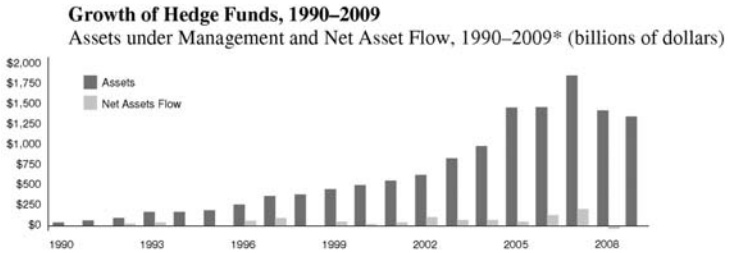
Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Subcommittee on Health, Employment, Labor, and Pensions hearing, "Creating Greater Accounting Transparency for Pensioners" held on July 20, 2010. MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies.

MFA appreciates the opportunity to express its views on the benefits that hedge funds provide with respect to pension plans and the beneficiaries of those plans and the legal requirements that must be met before a pension plan can invest in hedge funds.

Before doing so, I believe it is important to underscore the comprehensive and robust nature of the regulatory framework that applies to hedge funds and their advisers now that the Dodd-Frank Wall Street Reform and Consumer Protection Act has been enacted. All hedge fund advisers of meaningful size must register with the SEC under the Investment Advisers Act of 1940 (the "Advisers Act"). The responsibilities imposed on hedge fund advisers by the Advisers Act entail significant disclosure and compliance requirements, including: publicly available disclosure to the SEC regarding the adviser's business; extensive systemic risk reporting to the SEC; detailed disclosure to clients; policies and procedures to prevent insider trading; maintaining extensive books and records; and periodic inspections and examinations by SEC staff.

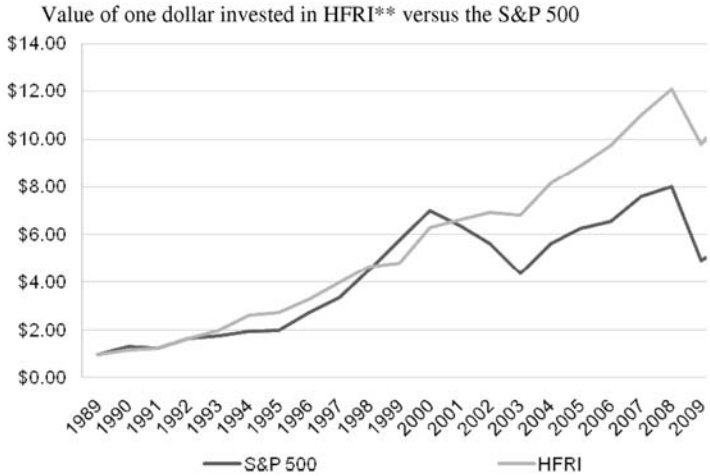
Benefits of investing in hedge funds

First and foremost, our industry consists of successful investment managers. As noted in the chart on the following page, and the charts included in Appendix A, the hedge fund industry has grown significantly over the last two decades. This growth is due to the value we provide our clients, which are predominantly institutional investors such as corporate and public pension plans, insurers, and educational endowments.



*Second quarter 2009. Estimates vary over the amount of assets and the number of funds. Research companies use different definitions and models to value hedge fund assets. Source: Hedge Fund Research, Inc. Available by subscription at: *www.hedgefundresearch.com.*

Hedge funds and other alternative investment vehicles are a valuable component of the investment portfolio for many pension plans. The properly managed addition of hedge funds to a portfolio provides diversification, risk management and returns that are not correlated to traditional equity and fixed income markets. These are critical benefits that help pension plan managers generate sufficient returns to enable plans to meet their obligations to plan participants. These benefits can be seen in the chart on the following page, which compares the value of one dollar invested in the Hedge Fund Research, Inc. Monthly Index (the "HFRI"), compared to the S&P 500 (with dividends reinvested).[1] The strong performance of the hedge fund industry can further be seen in the charts in Appendix B, which compare the performance returns of the HFRI versus the S&P 500 over the past 20 years.



**1989-1990 HFRI approximated with samples of roughly 90 funds from David Hsieh and William Goetzmann

The critical importance of hedge funds and other alternative investments as part of a pension plan's diversified portfolio was noted by Joseph A. Dear, Chief Investment Officer of the California Public Employees' Retirement System, in his written testimony before the Senate Banking Subcommittee on Securities, Insurance and Investment on July 15, 2009.[2] In that testimony, Mr. Dear stated that the performance of alternative investments:

> translates into substantial value added to the pension fund over a sustained time period. It makes realization of our target rate of return feasible. The

[1] The HFRI is one of a series of benchmarks of hedge fund industry performance created by Hedge Fund Research, Inc., which are designed to achieve representative performance of a larger universe of hedge fund strategies. More information about the HFRI, and the methodology used to create the index is available at: *https://www.hedgefundresearch.com/index.php?fuse=indicesfaq&1280757789.*

[2] Available at *http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e83f7ca16f94-4854-8aa9-ef0ac11b4bb0.*

> consequences to our beneficiaries, their government employers and taxpayers of our not meeting this objective are substantial and real: lower wages, higher contribution rates and higher taxes. Can these performance benefits be delivered through other investment products? No.

The value that hedge funds add to pension portfolios is also demonstrated through the significant investments made by pensions and endowments in hedge funds. Pensions and endowments in every state invest in hedge funds because of the benefits to their investment portfolios.

Finally, hedge funds are one of the best examples in the financial community of alignment of interests. Because the typical fee structure for a fund includes a performance fee whereby the manager receives a percent of the total returns the fund generates, hedge funds are motivated to perform for their clients. In addition, if hedge funds experience losses, those same performance fees do not start again until the fund earns enough in investment returns to get back to its earlier levels. These "high water marks" as well as the performance fees, and the lack of any government safety net, explain in large part the excellent risk management practiced by the hedge fund industry. Contrary to popular media portrayals, the "hedge" in hedge funds is real.

Legal qualifications for pension plans to invest in hedge funds

In order for a pension plan to invest in a hedge fund, two legal requirements must be met. First, the plan must qualify under the Federal securities laws as a sophisticated investor, typically as a "qualified purchaser" under the Investment Company Act of 1940 or as an "accredited investor" under Regulation D under the Securities Act of 1933. Second, the person who makes the investment decision on behalf of the pension plan must make such decisions consistent with his or her obligations as a fiduciary to the plan under the Employee Retirement Income Security Act of 1974 ("ERISA").[3]

Hedge funds provide significant benefits when appropriately incorporated into a pension fund's portfolio, however, as noted by the President's Working Group on Financial Markets' Investors' Committee noted in its 2009 report titled, Principles and Best Practices for Hedge Fund Investors (the "Investors' Committee Report"):

> Thousands of institutional and individual investors meet the legal requirements to invest in hedge funds, but it is not always appropriate for them to do so. Prudent evaluation and management of hedge fund investments may require specific knowledge of a range of investment strategies, relevant risks, legal and regulatory constraints, taxation, accounting, valuation, liquidity, and reporting considerations. Fiduciaries must take appropriate steps to determine whether an allocation of assets to hedge funds contributes to an institution's investment objectives, and whether internal staff or agents of the institution have sufficient resources and expertise to effectively manage a hedge fund component of an investment portfolio.[4]

We fully agree with the Investors' Committee Report that pension plan managers should consider not only whether the plans they manage are eligible to invest in hedge funds under the securities laws, but also whether an investment in hedge funds is consistent with the plan manager's fiduciary duties to the plan. Included in those fiduciary duties is the obligation on the plan manager, or the manager's representative, to conduct appropriate due diligence on the hedge fund and hedge fund's manager prior to making an investment, as well as appropriate ongoing due diligence once an investment has been made.[5] We believe that the combination of securities laws' thresholds and ERISA fiduciary obligations together work well to ensure that only pension plans with the appropriate sophistication and resources invest in hedge funds.

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[3] Section 3(21)(A) of ERISA provides that a person is a fiduciary with respect to a plan to the extent he (i) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

[4] Available at: *http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf.*

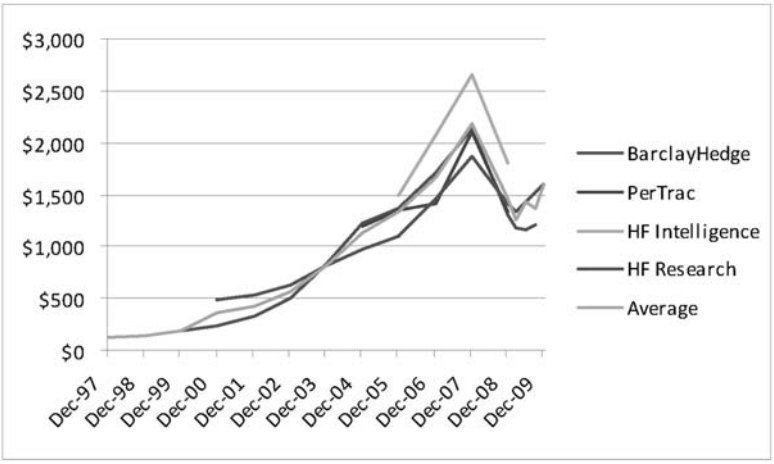
[5] Since 2000, MFA has been the leader in developing, enhancing and promoting standards of excellence for hedge fund managers through its document, Sound Practices for Hedge Fund Managers, which includes a model due diligence questionnaire for use by investors when considering an investment in a hedge fund. MFA's Sound Practices is available at: *http://www.managedfunds.org/mfas-sound-practices-for-hedge-fund-managers.asp.*

Conclusion

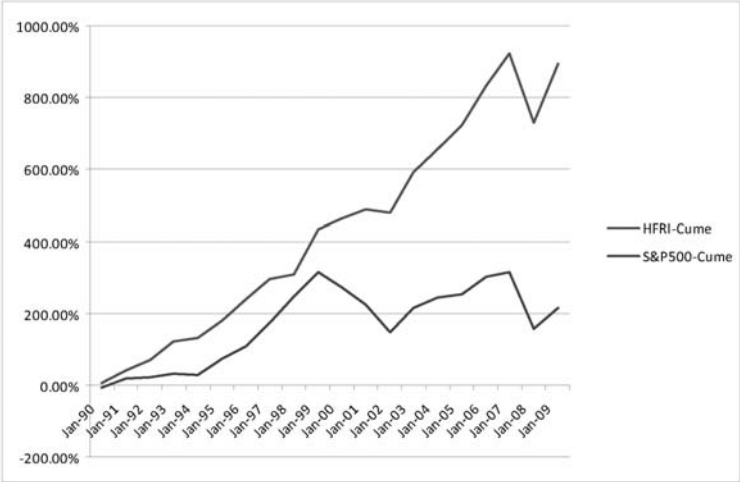
MFA appreciates the opportunity to express its views on the benefits that hedge funds provide with respect to pension plans and the beneficiaries of those plans and the legal requirements that must be met before a pension plan can invest in hedge funds. We would welcome the opportunity to elaborate on these points, or answer any questions that Subcommittee members or staff may have regarding our views.

GROWTH OF HEDGE FUND INDUSTRY ASSETS UNDER MANAGEMENT

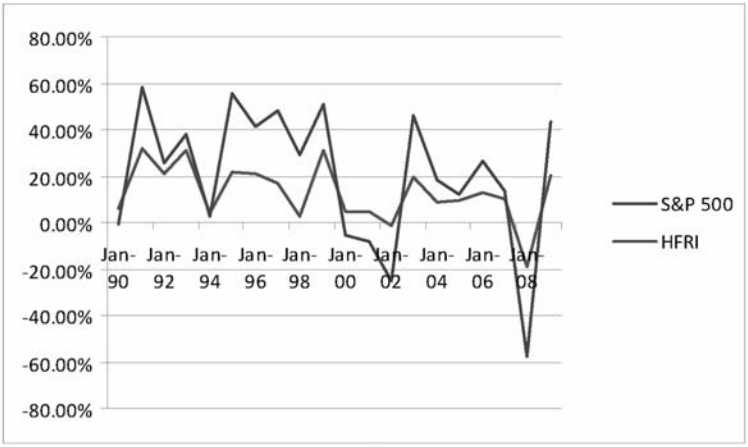
	BarclayHedge	PerTrac	Hedge Fund Intelligence	Hedge Fund Research	Average
Dec-97	$118				$118
Dec-98	$143				$143
Dec-99	$189				$189
Dec-00	$237			$490	$364
Dec-01	$322			$539	$431
Dec-02	$505			$625	$565
Dec-03	$826			$820	$823
Dec-04	$1,229	$1,200		$972	$1,134
Dec-05	$1,361	$1,350	$1,500	$1,105	$1,329
Dec-06	$1,713	$1,410	$2,070	$1,464	$1,664
Dec-07	$2,137	$2,100	$2,650	$1,868	$2,189
Dec-08	$1,297	$1,330	$1,800	$1,407	$1,459
Mar-09	$1,171			$1,331	$1,251
Jun-09	$1,169		$1,670	$1,430	$1,423
Sep-09	$1,205			$1,530	$1,368
Dec-09				$1,600	$1,600



COMPARISON OF RETURNS – HFRI VERSUS S&P 500 (DIVIDENDS REINVESTED)[6]



[6] Source: Hedge Fund Research Inc.—copyright 2010 HFR Inc. *www.hedgefundresearch.com.*



Date	HFRI	S&P 500	HFRI-Cumulative Return	S&P500-Cumulative Return
Dec-09	20.06%	23.45%	895.27%	215.53%
Dec-08	-19.03%	-38.49%	729.00%	155.59%
Dec-07	9.95%	3.53%	923.82%	315.50%
Dec-06	12.89%	13.62%	831.16%	301.33%
Dec-05	9.27%	3.00%	724.81%	253.22%
Dec-04	9.05%	8.99%	654.86%	242.93%
Dec-03	19.55%	26.38%	592.22%	214.63%
Dec-02	-1.44%	-23.37%	479.01%	148.96%
Dec-01	4.62%	-13.04%	487.47%	224.87%
Dec-00	4.98%	-10.14%	461.51%	273.59%
Dec-99	31.29%	19.53%	434.85%	315.75%
Dec-98	2.62%	26.67%	307.37%	247.83%
Dec-97	16.79%	31.01%	296.98%	174.60%
Dec-96	21.10%	20.26%	239.90%	109.60%
Dec-95	21.50%	34.11%	180.68%	74.29%
Dec-94	4.10%	-1.54%	131.00%	29.96%
Dec-93	30.88%	7.06%	121.90%	31.99%
Dec-92	21.22%	4.46%	69.54%	23.29%
Dec-91	32.19%	26.31%	39.87%	18.02%
Dec-90	5.81%	-6.56%	5.81%	-6.56%

[Whereupon, at 11:25 a.m., the subcommittee was adjourned.]

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