

**COMMITTEE ON EDUCATION AND THE WORKFORCE
U.S. House of Representatives**

**Subcommittee on Employer-Employee Relations
*The Pension Security Act: New Pension protections to Safeguard the
Retirement Savings of American Workers***

February 13, 2003

**Testimony of
Robert A.G. Monks**

“Conflict of interest is a very great evil”, Senator Jacob Javits, ERISA Forum 1985

The great tragedy of the Enron collapse is the loss of more than a billion dollars in company stock value in employee benefit plans. This committee is considering ways in which this horror can be avoided in the future through judicious amendment of the Employee Retirement Income Security Act of 1974 (“ERISA”). The language and structure of ERISA consistently evoke the historical common law of trusts, of which one of the most consistent and inveterate components is the requirement that trustees/fiduciaries act “solely” in and administer the trust assets “for the exclusive... benefit” of plan participants. The English language cannot communicate greater specificity or be less ambiguous.

The United States financial services industry is riddled with conflicts of interest, which have been exacerbated with the elimination of many restraints on conglomeration in recent years. The fact of conflict is not exceptionable. The issue is how this conflict is resolved. Today, the financial industry is volunteering to pay damages and reorganizing its service delivery because of damages arising out of poorly reconciled conflicting interests. There is no end in sight. Everyone wants to put behind them as quickly and thoroughly as possible the damages created by careless and willful abuse. It is indeed, odd, to contemplate proposed legislation to license conflicts.

The drafters of ERISA were acutely aware of the problem of conflicts and introduced the concept of “prohibited transactions” in order to minimize their potential for destructive impact. On the occasion of a conference commemorating the tenth anniversary of ERISA, Senator Jacob Javits, one of the primary movers of the legislation and then in poor health, was asked: “Can we not eliminate the ‘prohibited transactions’ concept and substitute a ‘facts and circumstances’ test?”. Javits asked for the lunch hour to reflect on the question. When he returned, he famously said, “We are dealing with a very great evil and we must continue the absolute prohibition.”

It is important to remember there is no obligation on any employer to provide retirement income programs. Policy makers must never lose sight of the need for companies to have real incentive to create plans. Public policy should incline employers to volunteer retirement and savings plans for their employees; the same public policy should encourage the use of employer securities, not as a favored species, but as yet another way to facilitate voluntary saving and prefunding of retirement expense. The difficult policy question is to define the scope of the obligations of

trustees with respect to employer securities in pension portfolios. Under the provisions of ERISA governing the preponderance of defined benefit plans, there is an absolute prohibition against plans holding more than 10% of the total assets in company equities. However, under the provisions relating to ESOPs and other defined contribution plans, higher percentages are allowed, even encouraged. There is inconsistency. There are unresolved problems of conflict for even an "independent" trustee.

At the time of this testimony, State Street Bank as a special trustee has asked for court instructions as to how to balance its seeming conflicting obligations as trustee of the United Airlines ESOP in the ongoing bankruptcy proceedings. The inconsistency can be resolved only through enforcing trustees' obligations rigorously to obey the "exclusive benefit" rule. Can one look at the Enron situation and see any evidence that the trustees of the employee benefit plans skeptically monitored the functioning of management "solely" in the interest of plan participants? Of course not. Why, such vehemence? In order to point out the real problem. What really caused the losses suffered by the Enron employees? Management and director failures – yes! But, amendment to ERISA can not address that problem.

As we have noted above, there is no failure of language defining the scope of the ERISA fiduciary's obligations. There has been, alas, an almost total failure of enforcement of this obligation by the Employee Benefit Security Administration ("EBSA"), formerly the Pension and Welfare Benefits Administration ("PWBA") of the Department of Labor ("DOL"). Until and unless this problem is solved, or at least mitigated, new language purporting to shelter employees from trustee negligence is redundant, misleading and, in fact, contributory to the real problem. Words will not fix conduct in the absence of enforcement.

Let's pause to consider briefly what is proposed. In the language of its sponsors: the proposal "allows employers to provide their workers with access to high-quality investment advice. Under the bill, financial service providers may provide specific investment advice to workers as long as they fully disclose any potential conflicts or fees. It also retains important safeguards and includes new fiduciary protections to ensure that participants will receive advice solely in their best interests." Under existing law (Interpretative Bulletin 96-1), a trustee may provide appropriate investment advice to beneficiaries using plan assets. The trustee is now inhibited from making investment advisory arrangements only with conflicted advisors. There is no shortage of qualified advisors. There are many who are prepared to offer competitive services at market rates. What is the benefit to whom of enabling conflicted advisors to participate, beyond the providers' natural desire for more business where they already have a relationship? Is this in essence the Fidelity Welfare Act? [I mention Fidelity with respect for its entrepreneurial dominance in this field.]

Investment advice should be considered in two categories. In the case of plans where employer securities comprise more than ten percent of the total assets, beneficiaries should be advised to consider the benefits of diversification. This kind of advice can be delivered simply and directly almost in the form of health warnings on cigarette packs. Beyond employer securities, advice has to do with asset allocation and the choice of securities. We can pause and consider how three million federal employees have dealt with this since the passage of the Federal Employees' Retirement Security Act of 1986 and the creation of a federal Defined Contribution scheme. Initially, employees were given three security choices – a special bond fund, a bond fund and an equity index – which has been the S&P 500. In recent times, two more options have been added. The experience with the Thrift Investment Board (created under FERSA) has been sufficiently

satisfactory to encourage investigation of this mode for all DC plans. In brief, there are alternatives tested on a fair sample of the American people for over fifteen years which could obviate starting down the slippery slope of eliminating conflict of interest prohibitions.

The problem presented by the Enron employee losses is not the need for clearer language describing rights. The problem is the practical one – how does an individual enforce these rights? How does a plan participant get his money back from a faulty fiduciary? Unhappily, neither of the two alternatives - private litigation or effective government enforcement - provides much hope.

ERISA does not give individual employees or beneficiaries the right to bring breach of fiduciary duty cases seeking their own compensatory damages. Although individual employees or beneficiaries may bring actions on behalf of a plan against a trustee for breach of fiduciary duty and obtain in such actions restitutionary remedies to reimburse the plan for its losses, the structure of ERISA as it now exists deters such actions and makes them a practical impossibility. There is also no money available from which to pay contingent fees to the employees' lawyers. Employees do not have the authority to dedicate plan assets to the payment of their lawyers' fees. The difficulty is that there is very little practical incentive for most employees, particularly non-management employees, to bring such actions, where there is no direct economic return to the employee and no direct economic recovery to support a contingent fee to the employees' lawyer. This does not mean that there are no cases in which employees can or have brought suits. (Attached as Exhibit I is the opinion of Attorney Peter Murray, published as Appendix II, in my *The Emperor's Nightingale*)

The amendment proposers boast: "The Pension Security Act would fix outdated federal laws and allow employers to provide their workers with high-quality, professional investment as an employee benefit, but also includes key safeguards to protect the interests of the workers and investors." It must be a commentary on the times in which we live that restriction against conflict of interest can be characterized as "**outdated federal laws**".

EBSA from its beginnings has been "tasked" under ERISA with responsibilities well beyond appropriations or institutional skills. There was a rather rude aphorism at the time of signing ERISA on Labor Day 1974. The bill's preparation had taken eleven years after President Kennedy on his way to Texas had signed the authorization of the study commission. It was said that ERISA, an act which pre-empted all state legislation in its field, would need be implemented by federal agencies having particular competency in the areas of personnel and finance. There were such, the Departments of Labor and Treasury. So, they gave the people to the Treasury and the money to the Labor Department. The few senior civil servants who were attracted to Labor were – and are – of the highest quality, but the Department had no cultural familiarity with the complexity of the financial service industry.

The real need is either to provide adequate funding for EBSA to create an enforcement capability and culture to monitor the "largest lump of money in the world" or to pass amending legislation giving the SEC or the Treasury, federal institutions with appropriate culture and competency, enforcement responsibility.

The ultimate fiduciary failure with respect to the Enron collapse was shareholder inactivity. Shareholders were responsible for the board. In the United States today, voting control of virtually all publicly traded companies rests in trustees, the scope of **whose responsibilities can be defined under existing federal law.**

EBSA has for almost twenty years been the leader in defining fiduciary obligation to inform themselves and to take appropriate remedial action with respect to companies whose securities are held in the portfolio. (U.S. Department of labor, Interpretive Bulletin 94-2, relating to written statements of investment policy, including proxy voting or guidelines, 7/29/94). EBSA has in recent weeks been paid the compliment of imitation by the SEC and the Federal Reserve, who respectively regulate mutual funds and bank trusts. The SEC has required appropriate activism for investment companies and advisors subject to the 1940 Act; the Fed has before it a comparable requirement for the trust departments of national banks. All that is now required is Administration leadership and the convening of a meeting of the Assistant Secretary of Labor for EBSA, the Chairman of the SEC and the appropriate Governor of the Federal Reserve. The agenda at that meeting should be the promulgation of "one government" policy on the duties of fiduciaries with respect to ownership responsibilities for securities held in the trust portfolio. This "reform" requires no new laws, no new agencies, and does not involve the elimination of time honored restraints.

Increasing evidence is emerging in aid of the conclusion that shareholder activism tends to protect against loss and to enhance value. A company comparable in many ways to Enron is Waste Management. These were the star clients of Arthur Anderson, whose partners were cited by the SEC in the Waste Management case long before Enron became a problem. Waste Management shareholders became actively involved; many of the leading institutional investors (including no ERISA plans) attended annual meetings and pressed directors and committee chairs for explanation. As of today, neither employees nor shareholders of WMX have losses. The question of trustee obligation to take appropriate action is not a simple one. It is, however, noteworthy that over the last twenty years, **there has never been a situation in which a private company pension fund (subject to ERISA, with the exception in recent years of CREF) has been publicly identified as an activist shareholder.** During this same time, public pension funds – not subject to ERISA - have very prominently and very profitably been activist. Perhaps, not coincidentally, **there has never been an enforcement action initiated by EBSA for the failure of ERISA fiduciaries to act in appropriate situations.** While the whole field of shareholder activism is in the process of gradual evolution, one cannot simply dismiss the double failure – failure by the largest shareholder group and failure by the regulatory agency – as an ignorable inconvenience.

EBSA enforcement failure reached its apogee in the recent merger of Hewlett Packard and Compaq. There is attached to this testimony as Exhibit II an article that I wrote for *Pensions & Investments* at the time of the merger in the spring of 2002, and, as Exhibit III, my fantasy as to a Decision by the Delaware Federal Court if EBSA had intervened and argued the ERISA issue in that case. The conduct in that case of Deutsche Asset Management is a matter of record and, as a plan fiduciary, accepting a fee for soliciting proxy vote, a per se violation of ERISA. This was not a small matter – the most important merger of 2002 would not have occurred had the law been enforced.

At the request of the then Chairman of the Senate Labor Committee the Government Accounting Office ("GAO") has scheduled a review of this matter to commence in March 2003 and will later in the year issue a report on its conclusions concerning EBSA enforcement of fiduciary requirements under ERISA. If there is a finding of systemic failure, the Congress would do well to listen to its auditor and pause before adding new responsibilities on to an already dysfunctional process. In the meantime, it is well to reflect that informed involvement by motivated owners is the best protection against the collapse of corporate values.